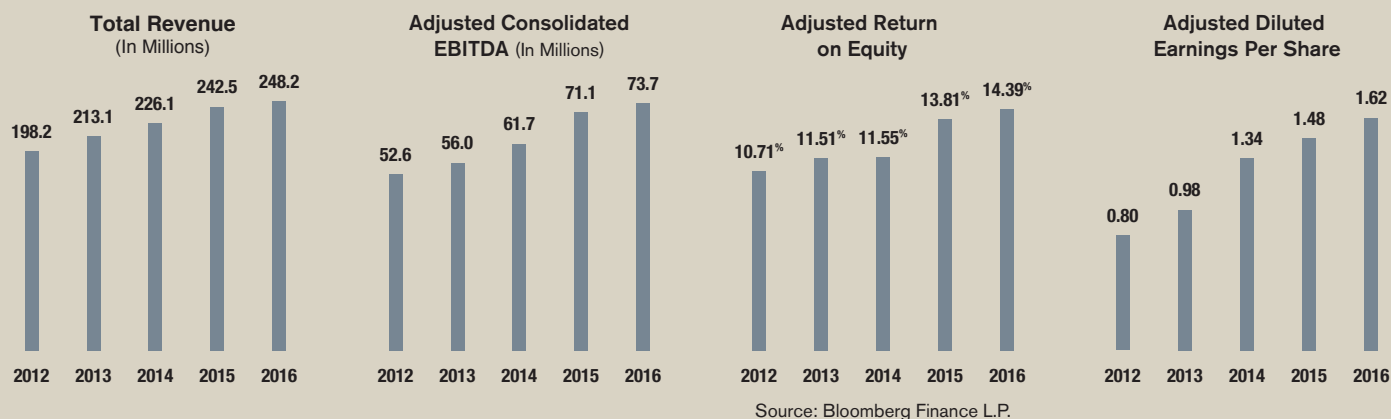


**CARRIAGE**  
SERVICES

25  
1991 - 2016

The Evolution Of Our Learning Journey

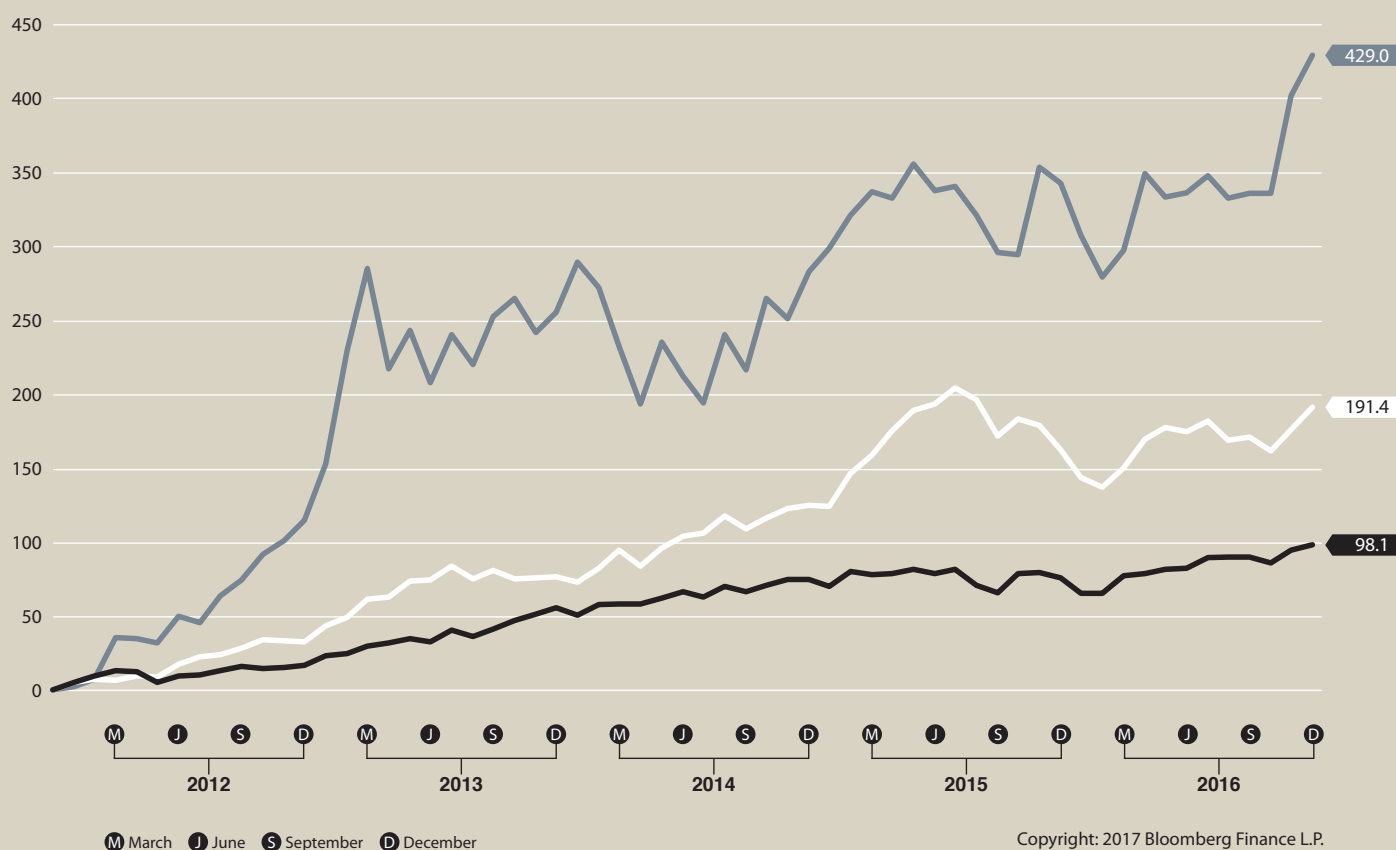
2016 ANNUAL REPORT



### Total Return 2012-2016 YTD December\*

\*Total Return includes stock price appreciation and dividend reinvestment

Carriage Services (CSV): 429.0%  
 Service Corporation Int. (SCI): 191.4%  
 Russell 3000 Index (RAY): 98.1%



The results after five full years of our five year Good To Great Journey launched on January 1, 2012 have been remarkable, as reflected in the Total Shareholder Return graph above comparing the five full years ending December 31, 2016 (since January 1, 2012) of Carriage (up 429.0%), SCI (up 191.4%) and the Russell 3000 Index (up 98.1%). Carriage's Total Shareholder Return since our Good To Great Journey began has been 429.0% and our stock price has increased 411% from \$5.60 per share on December 30, 2011 to \$28.64 per share on December 30, 2016.

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## Shareholder Letter

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*We recently reported our eighth straight record annual performance for 2016, which was the culmination of the first five year timeframe of **Carriage's Good To Great Journey** that never ends. Our achievements over the first five year **Good To Great** timeframe compared to our base year of 2011 were phenomenal, as reflected in the following highlights:*

- Total Revenue CAGR of 6.4%;
- Proforma<sup>1</sup> Adjusted Consolidated EBITDA CAGR of 10.8%;
- Proforma<sup>1</sup> Adjusted Consolidated EBITDA Margin increase of 550 basis points;
- Proforma<sup>1</sup> Adjusted Free Cash Flow CAGR of 16.1%;
- CSV share price CAGR of 38.6%;
- Total Shareholder Return of 429% including dividends.

<sup>1</sup> Excludes reported Non-GAAP withdrawable Trust Income from 2011-2015, a policy effective beginning in 2016 but shown for consistent comparative purposes on a proforma basis as if this policy was effective January 1, 2011.

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Key five year investment merit takeaways include the following:

- Increased by almost 23% our debt leverage capacity on the same revenue base;
- Increased by 111% our ability to self-finance from Free Cash Flow a more rapid pace of acquisitions;
- Substantially increased returns on invested capital of both our existing Same Store and Acquisition Funeral and Cemetery Portfolios;
- Increasing margin trends will materially benefit long term investment returns on future acquisitions using our Strategic Methodology whose criteria are predictive of future revenue growth;
- Substantially increased our financial flexibility to pursue additional opportunistic value creation capital allocation decisions; and
- Cash earning power Adjusted Consolidated EBITDA Margin of 29.7% is a company and industry milestone and is more than 300 basis points higher than our much larger benchmark competitor.

The operational and financial quantitative achievements along with the huge investment value creation benefits outlined above were driven since 2011 by an unrelenting and hard edged leadership focus on qualitative improvements at all levels and in all parts of our company as reflected in the following highlights:

- Creation of and “trial and error” Darwinian upgrading of senior leadership team (Operations and Strategic Growth Leadership Team) comprised of currently eight members (vetted from twenty three different members over five years) who are culturally and collaboratively aligned as leader owners of all parts of Carriage and will join me in leading the second five year timeframe of **Carriage’s Good To Great Journey** that never ends:
  - Mark Bruce, EVP and Chief Operating Officer;
  - Paul Elliott, SVP and Regional Partner;
  - Shawn Phillips, SVP and Head of Strategic Development;
  - Viki Blinderman, SVP and Principal Financial and Chief Accounting Officer;
  - Ben Brink, SVP, Chief Financial Officer and Head of Trust Investments;
  - Brijesh Patel, VP of Operations Analysis and Planning Group;
  - Gabe Ngo, VP and Head of Strategic Development Support.
- Upgrading of field operating and sales leadership across our portfolio of businesses under the leadership of Mark, Paul, Shawn and our field operations Directors of Support;
- Upgrading of leadership and processes of home office support departments, primarily driven by Viki, Ben, Brijesh, Gabe and Jeff Parker, Head of IT; and reorganization for more effective/ efficient support of our operating businesses, i.e. an overhead organization that will add value to our operating businesses and enable them to get better over time by becoming more successful at Standards Achievement;
- Cleaned up under the leadership of Viki and Ben our confusing Non-GAAP reporting so that Non-GAAP results beginning in 2017 would converge with GAAP results except for the accretion of the discount on our Convertible Subordinated Notes;
- New leadership under Ben and Viki for a more active and effective Investor Relations Program whose goal is to attract over time a community of institutional investors with a profile of long term shareholder partners;

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- New leadership under Shawn and Gabe for more effective execution of our Strategic Acquisition Model using updated and proven Strategic Criteria and Methodologies, the goal of which is a faster pace of high quality acquisitions over the next five years which have a higher revenue and earnings growth profile relative to our existing Same Store Portfolio (owned at least five years);
  - Creation in early 2012 of a Visual Schematic of Carriage's High Performance Culture Framework that depicts all the elements, linkages and dynamics of our operations, consolidation and value creation platform;
  - Creation beginning on January 1, 2012 of a new five year **Good To Great** value creation award based on sustained Standards Achievement which had twelve initial winners out of forty-three Managing Partner possibilities, each of whom received substantial pay-outs in February 2017, half in cash and half in CSV stock. As a group these winners had CAGR in Revenue and Field EBITDA over the first full five year **Good To Great** timeframe of 4.9% and 10.0%, respectfully;
  - Began to recognize quarterly in our earnings releases our quarterly High Performance Hero Managing Partners and in our Annual Report the annual **Being The Best Pinnacle of Service Award** winners as well as for the first time in our 2016 full year earnings press release and in this Shareholder Letter the twelve **Good To Great** value creation award winners.

The last section of my 2015 annual shareholder letter was titled "Carriage as a Compounder Company." This section articulated then and even more so now a passionate conviction that as the co-founder, Chairman, CEO and largest individual shareholder with literally "all my net worth eggs in the Carriage basket, I wish I owned a lot more of our company." In order for others outside our company to fully comprehend why at 74 years young I would so strongly feel this way (unwise and naïve at best, risky and completely stupid at worst), it will be necessary to retrace the first 25 year history of Carriage's Learning Journey.

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## The Two Part History Of The Evolution Of Our Learning Journey

Upon reflecting about how to write about our first quarter century of history, it seemed that breaking the Carriage Evolutionary Learning Journey into two parts made the most sense. Part I will cover the period from founding on June 1, 1991 to December 31, 2003, which is when we eliminated the traditional Budget and Control business model used across corporate America along with all the other time consuming and energy draining annual, quarterly and monthly budget processes and hierarchical management methodologies for operating and consolidating a highly fragmented industry.

On January 1, 2004, we began Part II of the Carriage history by implementing our innovative initial Funeral Standards Operating Model as a replacement for the Budget and Control Model and thus began a journey of learning, experimentation and continuous improvement over the next thirteen years that was defined by three distinct phases. First, we had to evolve into a good operations company before becoming a good consolidation company, which then led finally over the last five **Good To Great Journey** years to Carriage becoming a superior value creation platform for our industry, as reflected in our thirteen year performance history in the chart below:

### Carriage's Performance vs. S&P 500

Year	Return on Equity of Carriage	Percentage Annual Change Per-Share Book Value of Carriage	Percentage Annual Change Per-Share Market Value of Carriage	Percentage Annual Change S&P 500 with Dividends Included
2004	9.9	7.7	33.5	10.9
2005	(0.9)	(19.7)	1.2	4.9
2006	3.9	(0.8)	1.8	15.8
2007	7.2	7.4	72.9	5.5
2008	5.5	4.3	(77.2)	(37.0)
2009	6.7	7.8	95.5	26.5
2010	7.1	5.4	23.4	15.1
2011	7.0	4.4	15.5	2.1
2012	10.7	7.9	112.0	16.0
2013	11.5	15.0	64.5	32.4
2014	11.6	13.8	7.3	13.7
2015	13.8	(2.6)	15.0	1.4
2016	14.4	13.0	18.8	12.0
Compounded Annual Gain - 2004-2016		4.5%	17.1%	7.8%
Overall Gain - 2003-2016		77.2%	674.1%	164.0%

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## **Part I Overview**

I must provide upfront warning that Part I is a brutally honest and specific long confession of my leadership sins as co-founder, Chairman, CEO and only remaining corporate senior leader and Board Member survivor of Carriage over our first 12½ years, which was a process of unleashing institutional memories that were equal parts painful and liberating.

For those of you who believe in the uniqueness and sustainability of what we have achieved, especially over the last five years, you will find Part I informative and helpful toward understanding the motivations and excitement about the future of all our leaders and employees today, as well as what drove the initial innovation and subsequent thirteen year evolution of our High Performance Culture Framework. For the skeptics, which have far outnumbered the believers in the past, I'm not sure whether Part I will hurt or help. If nothing else you should conclude after reading Part I that our existing businesses, leaders, employees and company in 2017 have been "stress tested" over many years and are fantastically resilient and quite wonderful!

I have learned over my long career that the greater part of wisdom is first learning why a customary way of doing something is not always the best way for the creation of the most value (in this case, operating and consolidating funeral homes and cemeteries). This point is especially relevant given the significant differences in the current operating portfolio profiles of the two largest remaining public deathcare consolidators, SCI (bigger, more metropolitan and denser footprint of properties) and Carriage (smaller, more suburban and geographically distributed properties).

For anyone wanting to be the best at what they do, the biggest mistake and surest path to mediocrity is to simply copy and try to improve upon with incremental steps the methodologies and ways of thinking about how to do something that have been pioneered by others a long time ago. I would hazard a guess that more than thirty regional and national consolidators have started up in the highly fragmented deathcare industry over the last 30-40 years (vast majority backed financially by venture capital or private equity firms), all of which used a version (some more, some less) of the methodologies SCI had pioneered beginning in the early 1960's.

None of these consolidators were able to innovate and sustain a new operations and consolidation framework that sufficiently differentiated their long term operational and financial performance and attractiveness as a home to the best remaining independents. So eventually they all sold either directly or indirectly through bigger consolidators to SCI, enabling SCI to achieve Darwinian scale.

Because I had absolutely zero idea of how best to operate and consolidate funeral homes and cemeteries on June 1, 1991, we made the same mistake of simply copying what other consolidators had been doing for over forty years, i.e. trying to be like a little SCI, which wasn't possible because they were the first to acquire the biggest businesses in the biggest markets at historically discount prices with their pioneering consolidation and operation ideas in the 1960's, 1970's and 1980's.

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## **Part II Overview**

Part II will cover the evolution of our Funeral and Cemetery Standards Operating, 4E Leadership and Strategic Acquisition Models into what we now refer to as a High Performance Culture Framework for operating and consolidating the deathcare industry for superior value creation. Interestingly, I have come to the epiphany that none of the ideas and concepts created and evolved in Part II would have been possible if not for all the learning from mistakes in Part I. Moreover, I have also concluded that there was no way to short cut the dynamic and disruptive adaptive process of our evolution into a high performance culture company that just happens to be in the funeral and cemetery business.

Even though I have written extensively about our innovative and extraordinarily effective Funeral and Cemetery Standards Operating Models over the last five years, we believe these profoundly simple high performance ideas and concepts have not yet been very well understood, perhaps because of their extreme unorthodox and counterintuitive nature. This shareholder letter is another attempt to crack the “out of the box” thinking code for those of you interested in Carriage as a long term investment.

I decided to document in this shareholder letter critical periods in our 25 year history with three primary purposes in mind. First, only by studying history do we have any hope of not repeating the mistakes of the past. Second, to acknowledge and honor the first class Managing Partners and Former Owners who were instrumental in teaching me the right way of operating our high value personal services and sales businesses. And third, this shareholder letter will be a 25 year history sequential guide of the complex and often confusing nature of our dynamic and adaptive evolutionary learning journey.

Carriage over the last thirteen years has evolved into a laboratory for high performance culture continuous improvement ideas where the best ideas regardless of source win the day. But not surprisingly we find the best ideas bubble up from our High Performance Heroes and their employees in our operating businesses. I’m very proud of that state of affairs for our company in 2017 and would like to thank all the wonderful leaders and employees who have contributed to our success.



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## **Personal Preface To Founding Of Carriage Services**

Prior to co-founding Carriage in 1991, I had twenty-four years of personal learning journey experience that included two years of active military service including Vietnam (1966-1968); two years in Tulane's MBA Program (1969 - 1970); five years in the private placement department (10–15 year unsecured fixed rate high yield commercial and industrial loans) of Prudential Insurance (1971-1975); five years in the Chemical Division of Texas Commerce Bank (1975-1980); and ten years in the corporate restructuring and turnaround business (1981-1991), the last five of which was as the co-founder and senior partner in my own business.

During this prolonged formative career phase, there were a number of lessons learned and strong convictions developed that had huge implications for the future evolution of Carriage, which are highlighted below:

- Power of decentralized decision making by entrepreneurial leaders of small units or teams to achieve centralized enterprise goals or missions without a smothering top down central authority and bureaucratic organizational structure and culture (counterinsurgency teams in the countryside of Vietnam “winning hearts and minds” and Texas Commerce Bank);
- Power of providing high performance culture teams with four major elements of human motivation theory, i.e. Growth, Achievement, Responsibility and Recognition, glued together with generous high performance incentive structures (Tulane MBA Program);
- Fascination with why some companies in the same industry become great, some fail, but most are mediocre to one degree or another (Prudential Private Placement Department and Texas Commerce Bank);
- Operational and Financial Data Analytics and Trends over at least five years (unit volumes, prices per unit, store by store P+L analysis and trends, product line revenue and gross margin analysis and trends, seasonal and cyclical trends, etc.) can provide deep insights into where a company derives its Free Cash Flow and earnings power and whether it can be reliably sustained under stressful environments and grown under friendly environments (Prudential);
- Long life operating assets and permanent working capital requirements should be financed with a capital structure with long term liability components (Prudential);
- How to build a high performance culture company that just happened to be in the banking industry using a decentralized decision making organizational structure to achieve centralized high performance standards related to profitability of customer loan and deposit assets and associated ROIC (Visionary Chairman and CEO Ben Love of Texas Commerce Bank during a five year period when TCB went from second largest bank in Houston by assets to one of two Triple A rated banks in U.S.);
- Much more important and a lot more fun to be the best (as opposed to being the biggest) in an industry by the high performance standard of being the most profitable on a given portfolio of assets (ROA) and revenue (EBITDA Margin) which are the quantitative financial characteristics of a high performance culture that attracts the very best talent (Prudential and Texas Commerce Bank);

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- Cash Flow from operations and reliability and sustainability of FCF growth is the sustenance for a successful enterprise over long up and down business cycles (Prudential and turnaround business);
  - Excessive leverage is specific to an industry and company and is linked to predictability of cash earnings and sustainability of cash earning power of the enterprise – too much leverage and too little reliability and sustainability of FCF can be a company killer (Prudential and turnaround business).

It took me over three years to decide to co-found Carriage for a variety of reasons after being offered an acquisition line of credit subject to my personal guaranty from a new finance subsidiary of SCI that had been formed by former associates of mine from Texas Commerce Bank. Primarily, I was becoming successful in my restructuring and turnaround business and could not come to terms with the nature of death as a business in which I would spend the rest of my career.

My hesitation and doubts about a funeral business career disappeared when my brothers' oldest son (18 years) killed himself, his best friend in the passenger seat, and a mother of three small children in the other car in a tragic accident in Lawrenceville, Georgia in January 1991. The visitations for friends and family for all three funerals were handled by the same large funeral home in Lawrenceville on the same night.

After witnessing the noble work of the funeral director daughter of the owner, especially in her sensitive handling of each family and their interactions on that night, I told my brother and wife on the way to the Atlanta airport that I was highly even passionately motivated to start a funeral company that would over time become the best in the industry. At the time I had no idea how becoming the best at this noble work would be defined and measured or how difficult and long that journey would turn out to be.

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## **PART I: THE EVOLUTION OF OUR LEARNING JOURNEY**

I was able to secure a \$6 million funding commitment (PIK Preferred at 9% coupon) and 49%/51% common equity split for the three management co-founders and the wealthy individual financial investor, respectively, along with a \$35 million guidance line of credit with my personal guaranty from Provident Services, the finance company subsidiary of SCI. The good news is that I was able to negotiate governance arrangements with our wealthy financial backer (he and I were the only Board members) and buy/sell terms that let me build the company for the long term, which has not been the case for almost all other consolidators backed by venture capital or private equity (build and sell in 5 -7 years).

The greatest challenge we faced at the beginning was explaining the long term vision for our company and how that vision would be achieved.

Based on my prior experience and convictions, I wrote our **Mission Statement** and **Five Guiding Principles** on a single piece of paper, which we sent with a small cover letter to a group of funeral home owners in Texas doing over 100 funerals a year explaining that we would become a regional company of 35-40 firms (when asked, I said our geographic strategy was to go wherever Southwest Airlines flies!). We received two favorable responses to this outreach, one of which led to our first acquisition of a small business near Houston on January 26, 1992, eight long months after founding the company. No doubt about it – getting to first base is the hardest part of scoring and then winning the game!

As it has turned out 25 years later, the day we thoughtfully wrote down the vision and mission of what our company stood for and how we would think about the business and others who joined us over time was the day that forever changed the future course of our history. Nothing else since then comes close to the profound defining nature of these words:

### **Mission Statement:**

We are committed to being the most professional, ethical, and highest quality funeral and cemetery service organization in our industry.

### **Guiding Principles:** To Achieve Our Mission, We Are Committed To The Following Principles:

- Honesty, Integrity and Quality In All That We Do.
- Hard Work, Pride of Accomplishment, and Shared Success Through Employee Ownership.
- Belief In The Power of People Through Individual Initiative and Teamwork.
- Outstanding Service and Profitability Go Hand-In-Hand.
- Growth of The Company Is Driven By Decentralization and Partnership.

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## **From Founding in June 1991 To IPO in August 1996**

My dream and vision for Carriage was to become the best operator and consolidator in the industry, which I presumed would also lead to a very high valuation over time. Plus, it would simply be so much fun to collaborate on this idea with others who were likeminded about **Being The Best** at what they do and winning as a team.

I was coached and schooled by my former colleagues in SCI's acquisition finance company to focus only on funeral homes in the 100-300 annual calls range (industry language for atneed funeral volumes based on "first call" to a funeral home after a death). They explained the high FCF nature of the atneed funeral business (without aggressive preneed sales program) versus the low FCF nature (sometimes negative) of the cemetery business (unless large with huge heritage of burials) whose economics are driven by aggressive preneed property sales on typically 3 – 7 year financing terms requiring permanently large working capital.

My finance company former colleagues also schooled me on what normalized EBITDA Margins of revenue to expect (33%-36%) from operating good individual funeral home acquisitions and the customary multiples of EBITDA and revenue (6 times and 2.2 times) being paid for acquisitions by other consolidators during this period. And of course I was schooled on all the consolidation concepts that had proven highly successful for SCI since the early 1960's, i.e. clustering, scale and centralized vendor buying power, centralized pricing of products and services, and an aggressive preneed funeral sales program to create a large backlog of future funeral revenue and trust investments, etc., all earning power concepts that were intended to create efficiencies and as a result lead to higher Consolidated EBITDA Margins and Free Cash Flow.

However, none of my former colleagues schooled me on wise capital allocation to achieve superior investment returns on invested capital, which for a start-up with only overhead and no operations or history in the business would have been premature in any event.

Just as we were getting started as a baby company, the deathcare consolidation mania began to take hold and accelerate, driven by the proliferation of public companies (Loewen Group of Canada, Stewart Enterprises, ECI and SCI) and institutional investor demand for their equity and debt securities. There were also a significant number of private consolidators during the early to mid-1990's, all of which were subsequently acquired by either Loewen or SCI, which turned out to be a stroke of circumstantial luck for Carriage.

SCI acquired Arlington, Sentinel Group, and Gibraltar Mausoleum from 1991 to 1995 and began to view Carriage as the preferential buyer of properties they could not keep pursuant to FTC Consent Decrees as well as numerous others that they deemed undesirable or non-strategic at the time of our purchases. From September 1992 to April 1996 we acquired a total of twenty properties in four separate transactions from SCI that were mostly small businesses in smaller markets in Kansas, Michigan, Tennessee, Kentucky, Georgia, Florida and Texas.

These early SCI packaged divestitures along with our acquisition of numerous other independents during this formative period provided the critical mass to begin building the home office support and field operations infrastructure necessary to be both a successful operator and consolidator of independent funeral homes.

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As I have often said about this phase and later after the 1999 crash, we were in the lemonade business trying to turn around our acquired lemons into desirable businesses to own for the long term, which notwithstanding low purchase prices was a business that had very low returns on invested human capital. It was literally a PhD education in what not to do to build a successful company in our industry. However, learning what not to do is not the same as learning what is best to do, wisdom that came much later in our journey.

Because of our growth from 1991-1995, we twice raised additional equity, once in 1994 from a small group of wealthy young friends of our initial financial backer and again in late 1995 from an institutional pre-public investor when we were contemplating an IPO.

### **From IPO in August 1996 To Public Industry Market Peak in January 1999**

The public market mania around deathcare consolidation in the 1990's was driven by two major ideas, neither one of which turned out to be valid, at least not yet. First, only about 10%-12% of all funeral homes and cemeteries in that timeframe had thus far been acquired, meaning there were literally thousands of remaining acquisition candidates in our still highly fragmented industry. We have learned the hard way that only a small percentage but still a significant absolute number of remaining independent family businesses meet our highly selective strategic acquisition criteria in 2017.

The second compelling idea at the time was that the huge baby boomer population born after World War II were about to start dying and would lead to never ending and accelerating gains in revenue and profits for companies with a large footprint of portfolio properties in the U.S.

There was simply no way a management team or investor could lose in a "deathcare consolidation company", so big time greed by all parties settled in for almost ten years and was the order of the day. Almost overnight our mature, local revenue challenged industry turned into a "growth story" that every growth investor had to own.

We were courted to go public in late 1995 and early 1996 by numerous bulge bracket and regional investment banks as if we were in a "good" beauty contest. There were probably 9-10 sell side deathcare analysts covering the industry public sector, as secondary common equity issuances were necessary to fund the faster and faster pace of acquisitions. There were 6-8 active industry brokers and each decent acquisition candidate would have 4-6 offers from different consolidators (a "bad" beauty contest).

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## **GAAP Strategy – Growth At Any Price!**

We launched our IPO in August 1996 on the NASDAQ exchange through Merrill Lynch as our primary underwriter by issuing 3.9 million shares at \$13.50 per share, which increased \$3 per share on the first day of trading. Like all the public deathcare companies in the 1990's, our capital structure consisted of a Bank Revolving Credit with borrowings that grew rapidly because of acquisitions until we were leveraged to a degree that required a secondary common share offering whose proceeds were used to pay down our revolving bank debt.

Then the whole process was repeated again except faster, akin to getting on a treadmill that gets faster and steeper and eventually dangerous to get off even if you were inclined to do so. I actually considered stopping all acquisitions in 1998 but was concerned that our stock price would collapse and we would be acquired by one of the other consolidators, as I had already been approached several times by each of Loewen Group, Stewart Enterprises and ECI.

Armed and dangerous with about \$50 million of real cash equity from our IPO, we began to grow like a weed through acquisitions at increasingly high multiples of proforma future performance of “integrated” acquisitions (took ten more years to get good at the integrated part!). We expanded aggressively into the West including Northern California, Idaho, Nevada, Washington and Montana, as well as the Northeast, mid-Atlantic and Southeast including Massachusetts, Connecticut, New York, New Jersey, Maryland, Virginia, Indiana and Alabama. Our field operations and home office staff expanded exponentially to manage the budget and control model of the rapidly expanding and geographically dispersed portfolio.

Thinking back now about our comical acquisition and organizational structure strategy, it can be summed up in too many instances as, “If it’s a funeral home, cemetery or combination business, no matter where it is or what size, quality, demographic trends, etc., just buy it now because it will be worth much more later!” And if we have an effective manager of a single business, then promote him/her to an area manager, then regional manager, etc., until we have promoted them completely out of their area of competence, insuring their failure as a manager and simultaneously putting great stress on the businesses for which they were responsible. In other words, we absolutely mastered “The Peter Principle!”

We also had built a large group to find, analyze, negotiate and close acquisitions but not to effectively integrate them. We operated our rapidly growing portfolio of funeral homes and cemeteries through two separate geographically overlapping divisions, as the “service culture” nature of the funeral business compared to the “sales culture” nature of the cemetery business in our industry and with all public companies were historically akin to mixing oil with water.

We also had built up a nationwide preneed funeral selling organization that was 4 – 5 layers deep with percentage overrides from the top through every layer to the bottom layer where actual sales to client families were made. And finally, we bought a training company in 1998 to achieve our **Mission of Becoming The Best** and spent millions and millions training employees at each business over the next six to eight years without any lasting measurable result. We now have no institutional training program.



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## **Too Good To Be True To Stay That Way – January 1999 Market Crash**

Writing now about the public deathcare company mania and idiocy phase in the 1990's is more than a little humbling, especially as I believed at the time that my considerable prior experience and knowledge would surely provide me a leg up on spotting any red flags about gathering financial storms that were a danger to our company and the creditors, vendors and investors who believed in what we were doing. But when your share price goes from \$13.50 in August 1996 to \$29.25 in the first week of 1999, you begin to think, "Look at us – only in America - what a great country – what a great industry - what a great company!"

However, there were a few "data points" that caused me to begin questioning whether this accelerating public/private company arbitrage game was "Too Good To Be True" and therefore wouldn't stay that way. First was our annual company theme for 1998, "\$28 in 98!" In my own mind I'm still trying to live that one down!

Second was when a major institutional shareholder small cap portfolio manager from Boston flew to Houston in mid-1998 and hosted me for dinner at the city's best restaurant after our equity market capitalization had soared in less than 2½ years from \$130 million at our IPO to almost \$450 million at the end of 1998. He told me so much money was pouring into their equity funds that Carriage was being downgraded from a small-cap to a microcap and would be handled by a different portfolio manager! Ouch! I began to question what this meant for our sector and company and more generally the raging bull market of the 1990's.

Third, acquisition candidates had begun to be acquired on "proforma future 10% revenue increases and 45% EBITDA Margins" after the sale that were developed and presented to bidding "finalists" by industry brokers at nose bleed multiples that only made sense if the proforma future performance of the acquisition was achieved and sustained and public company Consolidated EBITDA multiples remained in the 12-14 times range.

Fourth, we began to be judged by "Mr. Market" on the growth and size of our "annual acquisition spend target" rather than on traditional fundamental metrics of shareholder value creation (capital allocation, FCF, EVA, ROIC, EPS, EV to EBITDA Multiple, etc.). As long as Mr. Market was accessible and encouraging for more and more acquisition mania activity, i.e. **GREED**, our sector share prices continued to surge. Our share price on the last trading day of 1998 closed at \$28.44, achieving our annual theme of \$28 in 98. Way too easy to stay true!

Finally, while we were growing rapidly in a sector whose stock prices were selling at 30 plus times proforma EPS based on acquisitions, Carriage was not producing any Free Cash Flow from operations, which I found increasingly alarming. This meant that we were completely dependent for cash and liquidity on borrowings from our bank syndicate and on the issuance of new common shares when we hit our leverage limit with our banks.

Moreover, I learned later after the deathcare public sector crash that the GAAP accounting for our sector at the time was much too liberal and resulted in book earnings being completely out of alignment with cash earnings, which changed substantially in 2001 under GAAP with the accounting rule SAB101 and again in 2005 when we no longer could capitalize and amortize over a long timeframe our preneed funeral selling expenses.

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During the Christmas Holidays at a ski resort in Telluride, I told my wife that all of our good fortune had come too fast and easy and seemed too good to be true to last. So on the first business day of 1999 I called Credit Suisse First Boston and initiated a five million share secondary offering (following one in May 1998 in a move to NYSE) whose almost \$150 million of net proceeds would be used to reduce the \$265 million of outstanding borrowings under our syndicated Bank Revolving Credit.

### **From Public Industry Market Crash in January 1999 to December 2003**

Much like the laws of nature and physics, sooner or later the chickens come home to roost, and so it was for our sector and company. Our stock price continued to rise in the first two weeks of 1999, hitting a peak of \$29.25. We were within three days of launching our five million share secondary offering when SCI announced a huge earnings shortfall for their Fourth Quarter and Full Year 1998 performance.

The deathcare consolidation mania had officially and suddenly ended as capital market access to the equity and syndicated bank markets began to erode rapidly and eventually over the course of 1999 access to any new capital was closed completely. Mr. Market got “fearful” and cancelled our equity offering!

Sector share prices collapsed with CSV falling like a rock from \$29.25 to \$17-\$18 by April 1999, where it hit buying resistance and stabilized for a while. Sensing that we should move fast to refinance our \$265 million Bank Revolver on much longer terms for protection against future financial dangers (hello – is anybody home in your brain?), we quickly found a tight but accessible capital markets niche for a hybrid security that was non-callable convertible preferred stock with the name of Tides Securities (convertible at \$20.44 per share) with a thirty year maturity, 7% coupon deferrable (PIK) for up to five years with no governance or cross default issues, deductible for tax purposes whether or not the coupon was paid in cash or PIK, and deeply subordinated to all debt including trade payables both in liquidation and priority of payments.

As a former debt guy, I could not believe this “made only in America” capital with mostly equity characteristics was available, so we raised \$90 million in April 1999 followed quickly in May 1999 by a \$110 million senior unsecured notes private placement with seven insurance companies (\$25 million maturing in four years, \$60 million in six years and \$25 million in eight years), using the almost \$200 million of total proceeds to pay down our syndicated Bank Revolving Credit borrowings from \$265 million to \$65 million.

These two quick financial moves later saved our company from bankruptcy but could not restore my reputation for integrity, which had been my most important personal characteristic and asset, especially with our own wonderful people and loyal and committed Former Owners and Manager Operating Partners. A significant number (8-10) of the Former Owners who joined their family business with the **Carriage Being The Best Family** of businesses had taken substantial amounts of their consideration in CSV shares because of our **Mission Statement** and **Guiding Principles** and my leadership of this vision for our company.

In August of 1999 Stewart Enterprises issued \$200 million of common equity at about \$11 per share, eventually saving them from bankruptcy, which was the last pure common equity raised publicly by a deathcare consolidation company up until today in 2017, a reflection of the amazing



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cash earning power that has been developed by both SCI and Carriage since 1999. Loewen Group filed bankruptcy in June 1999 and SCI, Stewart Enterprises and Carriage came close to the same fate over the next two years. The deathcare sector suddenly had almost no sell side equity analyst coverage – and no one cared!

Our inability to deleverage at the beginning of 1999 with a huge equity offering I now view as a gift or blessing that just keeps on giving, as we did not have a huge proliferation of new shares and common share overhang to deal with years later, inasmuch as we only issued public shares twice, once in our IPO in August 1996 and again in May 1998. Moreover, we were forced to Darwinian “adapt or die” innovate and create our own FCF equity to survive and later thrive.

## **Fresh Start Restructuring Program**

As we navigated through 1999 and 2000, we began to exhibit the same performance symptoms of declining revenues, earnings and equity market valuation that had plagued the public industry sector (but not the independent funeral and cemetery private sector) since the beginning of 1999. As a former “restructuring and turnaround expert,” it was time for bold and fast action, so I developed in collaboration with our lead insurance company (American General – later AIG) and lead bank (Bank of America) a comprehensive restructuring program named appropriately Fresh Start, which was developed with the following goals and principal elements:

### **Fresh Start Goals:**

- Increasing and better aligning our earnings and cash flow;
- Reducing our debt;
- Restoring market value credibility to our balance sheet;
- Re-accessing the capital markets;
- Restoring credibility to our operating and consolidation model.

### **Fresh Start Principal Elements:**

- Downsizing our corporate organization;
- Changing our operating leadership;
- Changing our preneed funeral organizational strategy;
- Stratifying by performance our funeral and cemetery portfolios;
- Implementing action plans to improve underperforming businesses;
- Disposing of some underperforming businesses;
- Adjusting the carrying basis of other underperforming businesses; and
- Modifying financial covenants with lenders to facilitate execution of Fresh Start.

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## **Questioning Who We Are And What We Stand For**

During early August 2001 we had a two day offsite retreat of our corporate and operational leadership team to revisit every word of our **Mission Statement** and **Guiding Principles** to see if that's where we had gone off track with our operating and growth strategy and to modify our **Mission Statement** and **Guiding Principles** if necessary. I still retain for its historical yet precious intangible value a marked up copy of our **Mission Statement** and **Guiding Principles** with the many recommended changes from that retreat. We did not ultimately change one word but over time every person who recommended a change was gone from Carriage.

## **Reading *Good To Great* – Learning We Were Not Yet Good!**

Later in 2001 we had another intended two day offsite retreat after the book ***Good To Great*** was published by Jim Collins. We were all excited to brainstorm how we would take Carriage from **Good – To – Great**, as Jim had profoundly stated that, “We believe that almost any organization can substantially improve its stature and performance, perhaps even become great, if it consistently applies the framework of ideas we’ve uncovered.”

I kicked off the retreat on a Saturday morning by asking whether anyone (7 - 8 leaders) had any ideas about the **Good To Great** concepts and how they could be applied at Carriage, but there was a long deafening silence. I then said I have a question to start the retreat related to the Hedgehog Concept in Chapter 5 that posed three questions that **Good To Great Companies** should be able to answer, as follows:

1. What are you deeply passionate about?
2. What drives your economic engine?
3. What can you be the best in the world at?

I thought the first two questions were laydowns for a weekend retreat, so I asked if anyone had an idea about what we could be the best in the world at? When there was another even longer deafening silence, I said, “Never mind - I’m sorry for being guilty of wasting everyone’s time. This retreat is over because it just occurred to me that this wonderful book is about going from **Good To Great** – and we are not even close to good! Forget the book and this retreat and let’s go back to work.” It would be another ten years before a new corporate leadership team and I revisited the framework of ideas in **Good To Great**.

By August of 2003 we had achieved most of the four financially oriented and measurable Fresh Start goals by implementing all of the principal elements and were clear for the first time in years of any near term financial crisis. We had finally been able to refinance the remaining borrowings from our crisis era large bank syndicate with a \$40 million credit facility from a two bank group.

The other important point to make about Carriage during the height of the financial crisis phase from January 1999 through August 2003 was that we were the only consolidator (and by far the smallest) to navigate this period without ever having any of our debt secured, without any covenant or payment defaults, without any shareholder lawsuits, without any financial restatements, and proudly were the only company in our industry to pass the Sarbanes-Oxley internal controls test on our first try and each year thereafter.

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I point out that Carriage avoided all these fundamental characteristic symptoms of risk because we hear often from investors that our relatively small size makes Carriage inherently more risky, unpredictable and prone to a negative surprise than much larger companies. We would diplomatically beg to differ with that view of the world.

However, I could not stop thinking about the fifth and most critical long term Fresh Start goal – restoring credibility to our operating and consolidation model.

### **Why Can't We Be Good At What Drives Our Economic Engine?**

Since Fresh Start had been initiated in late 2000, I had become increasingly dissatisfied with the operating and financial performance trends of our funeral and cemetery portfolios, as we were broadly losing market share under the operating leadership of our funeral and cemetery divisions. Much like a pied piper I toured repeatedly around our funeral and cemetery operating portfolio of businesses with our operating leadership harping over and over on the importance of market share volumes as the critical driver of local high performance and value creation. We had been “roughly right” tracking market share trends at each business each month for ten years by competitor in each market using obituary count.

### **Carriage's Ten Truths Of A Service Business**

I had actually begun to focus obsessively on this key local funeral service and cemetery sales and service revenue and earnings driver in 2001 by developing **Carriage's Ten Truths of a Service Business**, which were as follows:

1. Market Share Equates To Market Value.
2. Market Share Is: Heritage, Relationships, Goodwill, Outstanding Service, and Leadership.
3. Select and Grow The Right People and They Will Grow Your Market Share.
4. Market Share Growth Leads To Well-Managed Profitability and Vice Versa.
5. Market Share Growth Is A Building Process; Market Share Loss Can Happen Quickly.
6. Market Share Lost Is Growth Opportunity Lost.
7. Market Share Loss Is Bad; Not Knowing Where It Was Lost and Why Is Worse.
8. The Budget Is Not To Be Worshipped, But Rather Used As A Tool For Success.
9. Performers Must Not Pay For Under-Performers.
10. Manage Each Business Uniquely; Only Fools Manage Consolidated Results.

Our three year (2001 - 2003) funeral home portfolio performance trends in particular since 2000 had shown steady deterioration from market share losses and revenue declines in too many businesses because of weak managers and corporate field operations oversight in general. Our head of funeral operations simply did not hold managers accountable for weak or even bad performance.

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Our diverse portfolio of properties (about 125 funeral home facilities under 80 – 90 managers) were also characterized by mostly low Field EBITDA Margins with a large population of businesses having annual margins consistently in the high teens and 20%-30% range, another large population in the 30%-35% range, and a small but consistent group in the 36%-42% range with occasional annual outliers in the 43%-46% range. This smaller group of businesses in the 36%-42% Field EBITDA Margin range seemed to look more or less the same operationally and financially year after year no matter what their budget required.

The small high performance group (diverse in geography and size of business) also seemed less sensitive to the uncontrollable vagaries of their business and market (death rate variability, flu season severity and timing, cremation versus burial mix change, competitor moves, etc.). I began to wonder why the vast majority of our portfolio (85%-90%) couldn't perform like this small minority (10%-15%) of our portfolio.

### **Rethinking A Business Model Barrier To What Drives Our Economic Engine**

Yet no matter how many times I gave the sermon on the mount about the critical nature of market share volumes and the positive or negative impact of volume trends on the operating leverage dynamics of our high fixed cost local businesses, our operating leaders at all levels could not turn the tide of our broadly declining market share and associated operating and financial performance trends. I was constantly asking whether there was manager talent we could recruit to reverse declines in market share in a given business and market only to hear repeatedly "yes", but he/she is "the key employee" at a competitor and we can't afford them because that amount of manager compensation isn't in line with our pay policies and in any event "isn't in our budget."

So I took a three week vacation to Sardinia with my family, which was an opportunity for cleansing and freeing the mind for innovative thinking.

Upon returning home, we embarked on an improbable if not nearly impossible learning journey of business model and high performance culture innovation and continuous improvement that would increase our Total Funeral Field EBITDAR Margin (before rent but including financial revenue) almost 1,000 basis points from about 33%-34% in 2003 to 42.8% in 2016. Wow! That would not prove easy and seemed to take forever – but if it were easy, then anybody could do it!

### **Oh No It's Budget Season Again**

Each year I would kick off the funeral home budget season in August by getting a spread sheet with five years of relevant summary data on each business, listed by region (West, Central and East) and sub-region. The first column was the number of atneed funeral contracts (volume) by business by region, the second column was atneed average revenue per funeral contract (average revenue per unit of volume or ARPC) which when multiplied produced the third column, Total Revenue. The fourth column was the locally controllable business EBITDA without any accounting, field operations or home office overhead allocations, which was the metric I had initially learned to use for valuation of acquisitions and which we later in 2007 began to call Field EBITDA with our transparent Trend Reports. The fifth column was Field EBITDA Margin which was simply equal to Field EBITDA divided by Total Revenue.

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After reflecting on my historical knowledge of the performance trends of each business and market, I would “guesstimate” number of funerals, average funeral revenue, Total Revenue and Field EBITDA Margin improvement (or not) for the next budgeted performance year based on our specific operating management initiatives in that business and market. Then I would simply multiply the guesstimated EBITDA Margin times the forecast revenue to derive Field EBITDA for the next year. Then I added them all up to see how much potential improvement in Field EBITDA could be achieved in each sub-region, region and total portfolio in the next year.

But even though we tried to improve our budget process each year before pushing the highly detailed by line item preliminary format down to our managers for a final round or two of revisions and “buy in”, most of our budgets were out of whack with actual performance by April of the budgeted year. The focus of operations and corporate support then became managing and minimizing the biggest negative Field EBITDA variances to budget for the remainder of the year. Our monthly individual business reporting was purely financial (no operating data) with monthly, quarterly and year-to-date actual income statements compared to budgeted performance with variances shown in each case.

For purposes of our annual public company guidance, we discounted our budget by at least 15%-20% and eventually stopped providing annual and quarterly guidance at all, viewing this process and the Wall Street annual and quarterly EPS estimate system as weak short term thinking for a company wanting to be the best at what we do in the long term.

### **Giving Up On Budgets – Now What, But First Who?**

I had concluded on a Friday night after returning from Sardinia in August 2003 that after so many years under the budget and control model, this process was never going to work well enough for us to become a good operating company. More profoundly, I concluded that improving incrementally all the copy-cat methodologies that I had learned and employed for operating and consolidating funeral home and cemetery businesses would never achieve the fifth Fresh Start Goal of “Restoring credibility to our operating and consolidation model”.

In other words, it had become an impossible mission to restore credibility to an operating and consolidation model that in my experience with Carriage never should have had any credibility in the first place. Everyone did it this way because that’s always how it had been done. I committed to rid our company of budgets and all the time consuming processes related to them including our incentive programs and annual manager appraisals.

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## **Funeral Standards Operating Model**

Over the weekend I framed out eight simple funeral high performance operating and financial standards with the ones detailed in this paragraph evolved over the next three years from the initial version developed in August, 2003. These **Being The Best Standards** centered around market share trends (volume standard in the current year exceeds volume average of last three years, weighted 30% of 100%), average revenue trends (ARPC increases 2% annually, weighted 15%), profit margin trends comprised of three categories of earning power percentage ranges (Gross Margin Range % of revenue, weighted 10%; S&B Range % of revenue, weighted 12%; and Field EBITDA Margin Range % of revenue, weighted 10%), and finally bad debt as % of revenue, weighted 3% (leading indicator of future market share losses).

The Gross Margin and S&B Ranges were three percentage point ranges in a correlated matrix of four groupings related to volumes and ARPC, while the Field EBITDA Margin Range was four percentage points using the same grouping matrix. These three primary profitability percentage ranges along with the other high performance standards meant that the Standards Operating Model was designed to be flexible for decentralized decision making by our Managing Partners and is not designed for unsustainable maximum short term profitability, i.e. 100% Standards Achievement each year.

The standards are biased by the heavy weightings on the two revenue standards (45% total weighting on volume and ARPC growth) so that the model provides a flexible, local decision making framework for both short and long term operating and financial performance with a goal of organic growth in market share and revenue at sustainably high profit margins. We also have designed our two generous Managing Partner incentive programs (annual **Being The Best**) and five year **(Good To Great)** around high Standards Achievement through long term outstanding execution of our Standards Operating Model, which we have defined as averaging annually over 70% Standards Achievement.

Finally and most importantly, I implemented two people standards (Right Quality of Staff and Continuous Upgrading of Staff, each weighted 10%), although I had no idea how these people standards would be defined. My thinking then and even more so now is that, without highly motivated and skilled employees in a high value personal service business, you are nowhere and over time will lose market share as surely as night follows day. These people standards combined with the later focus on entrepreneurial leadership would turn out to be the critical drivers of the success of our learning journey.

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## **Best Business Operating Leaders As First Standards Council**

On Monday when I would have normally given my initial budget spreadsheet to our corporate operations and budget group, I instead called seventeen of our best Managers and Former Owners for a top secret two full days off-site retreat. No one at their business or in our field operations or home office would know the purpose of this confidential meeting other than this group of seventeen top field operating leaders and me.

After three days we had brainstormed and framed out on a whiteboard beginning versions of the eight simple standards detailed on the prior page (many more were proposed, discussed, debated and eliminated – for example, a standard for annual preneed funeral sales) that would constitute our first **Being The Best** Funeral Standards Operating Model. I told attendees at the retreat that I would write the new Standards Operating Model up and roll it out to all our funeral businesses (75% of revenue) effective January 1, 2004, and for the first time I would become head of operations and restructure, simplify and improve our funeral service strategy (e.g. random and unexpected service kindness for free) for serving our client families.

My thinking on our “high value personal service and sales business” then and now is that we are only limited by our imagination and the quality and mindset of our people who serve client families when they are most in need of “high value” services at the time of death of a loved one. The enemy of anyone wanting to be “great” in our business is the person looking at us in the mirror each morning who is willing to settle for “good”!

Because I wasn’t a funeral director, I thought that the idea of a Funeral Standards Operating Model would not have sufficient credibility for our field operating leaders and employees unless they all knew these seventeen well known and highly respected Managers and Former Owners as a group fully supported this dramatic change in how we managed our businesses and company. So I asked the group of leaders in this retreat to become Carriage’s first Standards Council responsible for Standards Achievement and thereby approval of **Being The Best** incentive bonuses for each Managing Partner and business at the end of each year, and to also provide oversight and control over any proposed changes to any of the **Being The Best** standards in the future.



## Funeral Standards Groupings – Flexible Nature of Decentralized Decision Making

Our funeral home portfolio today can be broken into four volume groupings of A-B-C-D each correlated in a matrix with four ARPC groupings of 1-2-3-4, meaning there are sixteen total subgroupings. Regardless of where a business in our portfolio is located geographically, it will fall into one of the sixteen subgroupings and have the same eight high performance funeral operating standards as every other business in its subgrouping.

Most of our portfolio today falls in our B and C Groupings with our A Grouping being smaller businesses performing fewer than 125 funerals annually and our D Grouping being bigger businesses performing more than 400 funerals annually. Shown below is a condensed version of the Standards Operating Model Matrix that reflects the eight subgroupings of only our B and C Funeral Groupings.

BEING THE BEST STANDARDS OPERATING MODEL									
Funeral Home Groupings	Group	B	C	B	C	B	C	B	C
	Funeral Contracts	125 - 250	251 - 400	125 - 250	251 - 400	125 - 250	251 - 400	125 - 250	251 - 400
	Group	1		2		3		4	
	ARPC	<\$4,500		\$4,500 - \$6,000		\$6,001 - \$7,500		>\$7,500	
Funeral Home Standards	Gross Margin %	87 - 89%	87 - 89%	86 - 88%	86 - 88%	85 - 87%	85 - 87%	85 - 87%	85 - 87%
	Salaries & Benefits %	28 - 30%	27 - 29%	26 - 28%	26 - 28%	26 - 28%	26 - 28%	26 - 28%	26 - 28%
	Bad Debt %	0.61%	0.61%	0.61%	0.61%	0.61%	0.61%	0.61%	0.61%
	Field EBITDAR %	37 - 41%	38 - 42%	38 - 42%	39 - 43%	39 - 43%	41 - 45%	39 - 43%	41 - 45%

Never could I have predicted at the time how this new analytical high performance standards framework for funeral operations would get traction and begin to evolve, slowly and very bumpily at first, until it had literally transformed, sometimes radically and Darwinian, every corporate and field operational aspect of our company over the next thirteen years.

## Back To The Future - Mission Statement and Guiding Principles

Reflecting back on our first 25 years of history, it is clear now that over the first 12½ years all the methodologies we used for operation and consolidation of our industry were completely out of alignment with most of the words in our **Mission Statement** and **Guiding Principles**. None of what Carriage has evolved into in 2017 would have been possible if not for the blessing of having affiliated with a large number of first class operating partners during our first 12½ years, as they were simultaneously my best teachers and cheerleaders on what we were doing right, but also my tough love coaches and critics on what we were doing wrong.

More than anyone else, they were responsible for the knowledge I gained that led to the idea of our Standards Operating Model and for bringing my leadership of our company back in alignment with our **Mission Statement** and **Guiding Principles**.



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When the world and Mr. Market are serving up one glorious gift after another (IPO, surging share price, son ringing bell to open NYSE on May 8, 1998, nothing but love from sell side analysts, investment bankers, etc.), you accumulate a huge community of “fair weather friends”. But when your sector and company finally get their comeuppance by having the “too good to be true” public company treadmill snatched out from under them, you find that all your fair weather friends have suddenly disappeared.

That’s when I turned for help to my real **First Who** “foxhole buddy operating partners”, who are proudly listed below by year of affiliation and to whom this 25th Anniversary Shareholder Letter is dedicated with honor and respect:

- 1992:** Gene Carlson (deceased) and Betty Carlson, Carlson Colonial Funeral Home, and Dick Morris, Kirby Morris Funeral Home, El Dorado, Kansas;
- 1992:** Bill Fields, Steen Funeral Homes, Ashland, Kentucky;
- 1993:** Ed English, Lane Coulter Funeral Home, Redbank, Tennessee;
- 1993:** Jimmy Williamson (deceased) and sons Gabby and Chuck Williamson, Williamson & Sons Funeral Home, Soddy Daisy, Tennessee;
- 1993:** Butch Williamson, Lane Southcrest Funeral Chapel, Rossville, Georgia;
- 1996:** Dwayne Spence, Dwayne Spence Funeral Homes, Canal Winchester & Pickerington, Ohio;
- 1996:** Ron Duhaime and son Chris Duhaime, Funk Funeral Home, Bristol, Connecticut;
- 1996:** Tom O’Brien, O’Brien Funeral Home, Bristol, Connecticut;
- 1996:** Doug Reinke, Dakan Funeral Chapel, Caldwell, Idaho;
- 1997:** Jimmy Shemwell and Wayne Pearson and Jimmy’s sons Brad and Andy Shemwell, Latham Funeral Home, Elkton, Kentucky, and Maddox-Fuqua Hinton Funeral Home, Hopkinsville, Kentucky;
- 1997:** Mark Wilson, Wilson & Kratzler Mortuaries & Rolling Hills Cemetery, Richmond, California;
- 1997:** Dan Stevens, Baker Stevens Funeral Home, Middletown, Ohio;
- 1997:** Greg Brudnicki, Kent-Forest Lawn Funeral Home & Cemeteries, Panama City, and Emerald Coast Funeral Home, Fort Walton Beach, Florida;
- 1998:** Jack Fischer (deceased) and son Jeff Fischer, Darling & Fischer Mortuaries and Los Gatos Cemetery, San Jose, California;
- 1998:** Frank Forastiere, Forastiere Funeral Homes, Springfield, Massachusetts;
- 1999:** Dorn Rademacher, Relyea Funeral Chapel, Boise, Idaho;
- 1999:** Chuck Hennessey (deceased), Hennessey Funeral Homes & Crematory, Spokane, Washington.

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## PART II – THE EVOLUTION OF OUR LEARNING JOURNEY

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Implementation of our Funeral Standards Operating Model on January 1, 2004 was consistent with the idea that in order to become the best consolidation company we first had to become good at operating funeral homes and cemeteries.

Our abbreviated **Mission Statement** of **Being The Best** then came to mean maintaining or modestly growing our annual number of funerals and cemetery interments at each business (market share) and average revenue per funeral and interment over time at slightly increasing and sustainable Field EBITDA Margins that reflected the positive financial impact of local operating leverage through our high fixed cost facilities. Our portfolio of cemeteries was not large enough to develop a comparable cemetery operating model at that time, so we deferred its development until the funeral model could be tested against several years of data for effectiveness.

### **Early Years Of Trial & Error: 2004 – 2005: Getting To The Other Side**

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There was very little financial performance improvement in our funeral portfolio in 2004 and 2005. And I was actually shocked after two years of Funeral Standards Achievement data, although admittedly I did not know what to expect with the new framework at the beginning of 2004. Our consolidated portfolio Funeral Standards Achievement was less than 50% and we still had many businesses below the minimum Funeral Field EBITDA Margin of 33%.

When we initiated the Standards Operating Model at the beginning of 2004, we had about thirty-five people in Corporate Operations both in support groups in Houston and located regionally to manage performance in our portfolio previously utilizing the Budget and Control Operating Model. With mounting frustration over our lack of progress in 2004 and 2005, I began to terminate our five funeral regional managers one by one.

It is a fascinating “data point” now to note that only two of that original thirty-five corporate operating team personnel made it past the major management reorganization on November 4, 2011 (me and Peggy Schappaugh, who is now the Manager of our Operations Analysis and Planning Group who had been hired in August 2003 “to do budgets”). All thirty-three people who eventually didn’t make the cut (and many others who replaced them) were highly competent with a budget and control model and the associated processes and hierarchical layers of management authority that syncs up with a top down model of performance management.

We have learned through large amounts of turnover and the regrettably high cost of turnover that previously successful operating and financial people can’t make the adjustment to a completely new and decentralized way of adaptive thinking about the locally complex dynamics of our business. A history of hierarchical top down experience means in most cases they can’t “mentally and behaviorally compute” that our leadership goal is to give up complete centralized operational control and decision making to a “**Right Who** Managing Partner” who would be able to lead a local highly motivated and skilled team of employees in a Carriage operating business to a high and sustainable level of **Being The Best** Standards Achievement.

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We now refer to a leader who joins our company from a career of success somewhere else as needing to get to “the other side” where the rest of us live, work and play in a high performance culture world. It typically takes someone new 18-24 months to get to the other side but most don’t make it. We are shameless analogy thieves, which we use internally for effective communication in our High Performance Culture Language, but we also give credit where credit is due. We stole “the other side” high performance culture analogy from Ray Dalio and Bridgewater Associates.

The bottom line after two full years of operating under our Funeral Standards Operating Model was that the idea did not seem to be broadly working and we were still clueless on our two people standards weighted 10% each or 20% of Total Standards. Something had to be done to change this “going nowhere fast” performance trend. But first, let’s pause to reflect upon what we know now in 2017 but didn’t know in the first 12½ years or even well enough in 2004 and 2005.

### **From Founding Until Now - Wish I Had Known Then What I Know Now**

I have learned by talking about and presenting our company to institutional investors over the last twenty plus years as a public company that there is generally a very weak understanding about the local and very entrepreneurial nature of our business. There is a strong institutional investor bias to viewing SEC sector reporting consolidated results as meaning more than they actually do because at the individual business and local market level our business is very entrepreneurial and dynamic with different competitors in a never ending war for more market share.

What is fascinating is the similarity of the local competitive market dynamic in our industry to the concept of counterinsurgency, a concept that was formulated and developed by the U.S. in Vietnam (British in various places before that), the central element of which was to “win the hearts and minds” of the local people living in the hamlets and villages of the countryside. As a young lieutenant on the front lines of pioneering this concept in Vietnam in 1967/1968, I learned that our “civil affairs” teams of about 6-7 soldiers each were only as effective as our entrepreneurial leadership and the ideas we came up with for the people to help themselves with our organizational and financial support for supplies acquired locally (no reliable military supply chain).

Each area of the Vietnam countryside was different with a huge diversity of ethnic groups, religions and geographical and topographical variances, and most importantly the level of as well as nature of insurgent activity, so the local needs and ideas that worked best for our seventeen teams across the country were just as diverse. What became crystal clear very quickly, however, is that none of the senior commanders up the chain of command had a clue what to do. In other words, “cookie cutter counterinsurgency” just didn’t “cut it” and would have been as effective and sustainable as our 1998 Carriage theme of \$28 in 98!

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The same local diversity dynamic holds true with the nature of each of our local businesses and markets, as our home office and field operating organization can't possibly know on a 24/7 basis what to do to effectively deal with the complex competitive dynamics of each unique local business and market. The best we can do is get the right entrepreneurial leaders in each business and support these “**Right Who**” leaders to be successful at growing their business over time. I have recently outlined these points in Carriage’s written materials, all of which have been institutionalized over the past thirteen years into our core convictions and beliefs about our company, business and industry:

- High Performance Ideas and Concepts of Carriage are 100% aligned with our **Mission of Being The Best** and **Five Guiding Principles**, which are the Qualitative Elements that drive our High and Sustainable Quantitative Performance;
- Words in the form of ideas, concepts, high performance standards, recognition, Mission, Vision and Guiding Principles matter greatly to people with exceptional talent, especially those who are part of high performance teams – so over time we have developed a unique Carriage High Performance Culture Language;
- Nature of each of our businesses is high value personal service and sales delivered locally through highly motivated, skilled and culturally aligned leaders and employee fully involved in their communities;
- Nature of each market in which we operate is highly competitive for market share with each market and Carriage business being unique as to its competitive opportunities and challenges that are not prone to centralized solutions or top down initiatives;
- Weak leadership locally will make a healthy and/or dominant business weaker in competitive standing (market share) over time, whereas strong 4E Leadership and the “Right Quality of Staff” in a Carriage business will produce high and sustainable performance from a good business almost overnight, consistent with the high performance concept of **First Who, Then What**;
- A few simple high operating performance standards that do not change over time weighted heavily toward long term growth in funeral volumes and preneed cemetery property sales, which are the primary drivers of locally produced economic value creation through the financial dynamic of operating leverage, attracts the top entrepreneurial and competitive talent to Carriage businesses that do not need to be managed – just supported, recognized and rewarded like a partner; and
- Nature of our industry is akin to “birds of a feather flock together”, as we have found that making Carriage highly selective on acquisitions and talent is attractive to the best remaining independent businesses and top entrepreneurial talent who want to join an elite club of “Only The Best” Carriage businesses and Managing Partners.

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## **Learning And Adapting With Four Major Turning Point Moves In 2006 and 2007**

We made three major turning point moves in 2006 and one in 2007 that would greatly accelerate our learning journey and lead to much higher operating and financial performance in the future.

After observing the Standards Achievement data from 2004 and 2005, we had a surprising epiphany, as follows:

- Managers that we previously viewed as A Players were mostly B Players who could manage their business performance to a negotiated budget but could not grow market share volumes through highly motivated and skilled staff over time (the key operating driver for the financial dynamic of operating leverage);
- Managers that we previously viewed as B Players were actually C – or D+ and in the past only got circumstantially lucky to achieve their budget performance because of positive external factors, i.e. an increase in deaths in their market, a negative change in ownership or management of a competitor, etc.;
- Managers that we previously viewed as C Players were F's and all had to go!

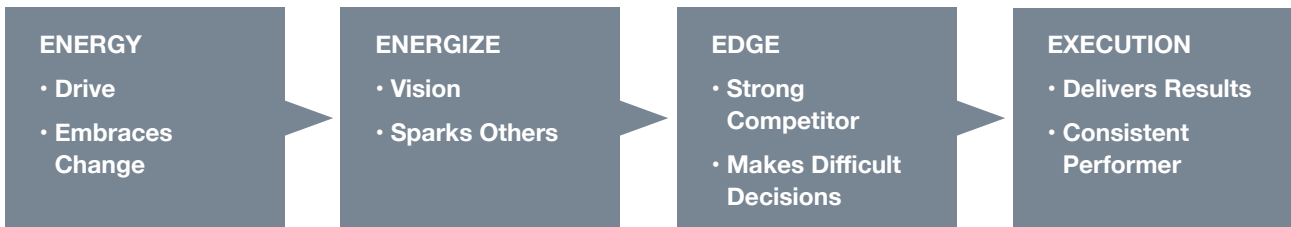
It became observably obvious at this point that our Standards Operating Model was not a “management model or management system” akin to the budget and control model. It was much more of an entrepreneurial leadership model requiring leaders who were hungry for more business and skilled at coming up with ideas and ways to beat their local competition in the constant battle for market share.

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## 4E Leadership Model

In April of 2006 we made our first turning point move when we adopted the 4E Leadership Model as the Carriage Leadership Model for assessing and recruiting Managing Partners to lead each business as well as to profile and assess all other members of corporate leadership. The 4E Leadership Model had been developed under Jack Welch when he was CEO at General Electric and I had become familiar with it over the years as a student of his evolving view of leadership versus management during my career as a turnaround professional.

We got really lucky when a book titled “**Jack Welch and the 4E’s of Leadership**” was written by Jeffrey A. Krames and published in 2005. It was a simple to understand model which I thought fit our company and the nature of our business well. Moreover, we could customize the elements of the model for our organization, all of which aligned perfectly with our **Mission Statement** and **Guiding Principles**. Its sequential 4E Leadership elements sandwiched between personal characteristics of integrity and passion were as follows:



After adopting our new 4E Leadership Model, we assessed all of our managers in April 2006, which reflected that we had to replace about thirty-three Managing Partners. This group comprised about 40% of our total and were concentrated in our Northern California, Central Region and Mid-Atlantic and Southeastern portfolios. We began to replace and recruit new managers at an accelerating pace. Since 2006 we have continuously evolved the calibration and definition of 4E Leadership characteristics and now find attracting 4E Leaders as Managing Partners for our portfolio of businesses has become much easier because of our reputation of empowering top talent and recognizing and rewarding them generously for high performance.

## Beginning of Organizational Structure and Culture Transformation

The second turning point move in 2006 was when we collapsed our cemetery and funeral divisions together, meaning we had decided to have one high performance culture aligned with our **Mission** and **Vision of Being The Best** whether in the funeral or cemetery business. And anyone who wasn’t a “**One Team, One Vision**” collaborative team player, well – NEXT! We then developed a simple new Cemetery Standards Operating Model (back of the envelope but with five years of data). We implemented the new cemetery operating framework on January 1, 2007 and it has evolved and advanced since then under our operating and sales leadership and Standards Council.

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## Strategic Acquisition Model

The third turning point move in 2006 was development of our first Strategic Acquisition Model. We analyzed the operating and financial performance of our entire funeral and cemetery portfolio for the five years ending December 31, 2005 and ranked every business as A, B or C based on their performance but also on longer term performance driving characteristics such as market size, business size, competitive standing (market share) trends, burial/cremation ARPC mix trends, demographics, strategic nature of business and market, i.e. could it be desirable in the future to invest more capital for growth, etc. From this analysis we developed our first Strategic Acquisition Model and set five and ten year plans for growth by acquisition from cash and Free Cash Flow.

Beginning with the initial Strategic Acquisition Model with six criteria that were poorly defined, we have evolved over the last twelve years a Strategic Growth Framework and Capital Allocation Strategy for long term value creation using our Strategic Ranking and Strategic Acquisition Valuation Methodology shown below.

Strategic Ranking and Strategic Acquisition Methodology		Weighting
1	Seller Motivation Alignment	5%
2	Large Strategic Market	15%
3	Large Strategic Business	15%
4	10 Year SS Volumes	15%
5	Average Revenue Per Contract	15%
6	Competitive Standing Trend	10%
7	Burial/Cremation Mix Trend	10%
8	Demographic Trends	5%
9	Institutional Brand Strength	5%
10	Barriers to Entry	5%
TOTAL		100%

Our senior leadership team has practiced the above qualitative ranking methodology on many acquisition candidates over the last several years (most that rank less than 60% don't make the cut). We use three easy to obtain pieces of information before collaborating as a team on a Strategic Ranking for an acquisition candidate: ten years of volume history by business location (reflects market share trends); three full years and YTD interim of individual client family contract data (reflects trend in client family revenue profile); and finally, operating team "boots on the ground" assessment of the facilities and market of the candidate and all competitors.

We have determined from all of our ranking practice that a total ranking between 60%–80% is the sweet spot for new acquisitions that have predictability of higher revenue and earnings growth over the first five to ten years of our ownership and which will be able to sustain high Standards Achievement under the framework of our Standards Operating Model. Over the next ten years our goal is to add larger businesses in larger markets that rank high using our Ten Strategic Criteria so that over time our total funeral and cemetery portfolio will take on a higher growth and earnings profile as well.



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We are targeting businesses that rank in the high 60% and above range realizing that these will also carry higher initial Field EBITDA acquisition multiples which nevertheless over time will prove justified based on long term returns on invested capital. Our vision over the next ten years is to add a larger volume grouping to the four volume groupings in our existing funeral portfolio, perhaps a category with annual funeral contracts from 400-700 and a final grouping of 700 and over, which would mean adding higher margin businesses that would continue the upward trend over the last five years of our Adjusted Consolidated EBITDA Margin.

In early 2005 we had publicly issued \$130 million of ten year unsecured 7½% high yield senior notes and used the proceeds to refinance the remaining borrowings on our \$45 million secured Bank Revolving Credit as well as the \$85 million remainder of our privately placed insurance company unsecured senior notes, brought current our eighteen months of deferred PIK interest on our Tides Securities, plus put \$10 million cash in the bank while we continued to focus on operations and FCF. We had finally become completely clear of debt issues with no maturities for ten years, adequate annual fixed charge interest (\$18 million) coverage and money in the bank.

So during 2005 and 2006 we began to selectively divest properties that did not fit with the characteristics of a business that could achieve at least our Minimum Standards. By the end of 2006 we had accumulated \$42 million in cash on our balance sheet from FCF and divestitures and were prepared financially and by that time operationally under our Standards Operating Model to resume selective growth by acquisition using our new Strategic Acquisition Model framework.

As we were bringing 2006 in for a close, I was getting increasingly excited by the substantial improvement in our funeral portfolio operating performance and the target acquisition candidate list of new and bigger businesses in larger markets that were strong possibilities for closings in the first half of 2007.

Then something quite weird and wonderful happened just before Christmas that had huge turning point consequences in 2007 and thereafter.

### **Just When You Think Carriage Is Becoming Good – SURPRISE!**

I received a phone call from a Lehman Brothers investment banker who had a client that wanted to buy Carriage for \$6.25 cash (we were trading for less than \$5 per share and had \$2.50 per share in cash!) and was willing to pay me whatever it took to exit gracefully, as they already had an experienced, successful CEO from the industry to take my place.

The offer to purchase Carriage followed a disastrous third quarter conference call when I was asked whether we could sell our entire Central Region and most of the Western Region funeral portfolio since it was obvious we couldn't turn them around, as well as whether we could sell Rolling Hills, our largest cemetery in Richmond, California for the same reason. I was stunned because I had been looking at our improving individual business Field EBITDA performance trends (and all the weak manager terminations) and found out after the call that the investors were looking at our SEC filings! What's wrong with this picture?



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I later determined that our Chief Accounting Officer at that time had not accrued over the last several years an almost \$2 million long term incentive payment to a Former Owner Operating Partner who had acquired our northern California portfolio in 1997 and 1998 under a ten year partnership ending at year end 2006. Our Chief Accounting Officer had allocated this huge one time incentive payment (due to this portfolio performing so well compared to our acquisition underwriting performance) down to all of our northern California operating businesses, making it appear as if they were performance dogs in our SEC filings. Moreover, Rolling Hills had recently incurred a one-time \$800,000 environmental cleanup charge, which also made it appear to be a turnaround candidate.

The proposed buyer of Carriage turned out to be a large private equity buyer with \$32 billion under management at the time. I met with the principal in late January 2007 and was able to buy time until we released our 2006 Full Year and First Quarter 2007 Earnings Press Release.

We had a record 2007 first quarter operating performance and closed two large combination acquisitions in Corpus Christi, Texas and Camarillo, California, two of the seven acquisitions closed in 2007 with Total Revenue of about \$25 million, all with eventually very high Field EBITDA Margins.

### **Long and Short Term Non-GAAP Performance Trend Reports**

Because of the confusing cost accounting for one time special items in 2006 that I concluded had triggered the friendly but serious takeover offer for Carriage, I had all of our accounting staff read the book ***Beyond Budgeting*** co-authored and published in 2003 by Robin Fraser and Jeremy Hope. I wrote extensively in our 2016 second and third quarter earnings releases about this book and the extensive research by its authors on business models that move “***Beyond Budgets***”. Our operations and accounting teams then held a brainstorming session for purposes of developing longer term “trend reports” that would track the improved execution of each of our businesses under the framework of our Standards Operating Model and the subsequent increases in our operating and financial performance.

Our fourth turning point move in 2007 was to create an innovative framework of short and long term Non-GAAP Performance Reporting more suitable for our unique operations and consolidation framework.

We framed out new reporting for each business on a monthly basis called field operating and financial trend reports. These reports include four full years of operating and financial data plus the most recent rolling twelve months on the left side and on the right side the most recent three months and rolling three months with comparable data from the prior year. Finally, we show comparable year to date performance to the far right. This data captures locally controllable cash operating performance without the burden of confusing accounting allocations from the “suits up the chain of command!”

Since we had no more budgets, we also had no actual to budget variances to be concerned about, so instead we show the six **Being The Best Quantitative Standards** beside each of the appropriate actual performance standard metrics to reflect whether the business is achieving each standard or trending toward achievement during the balance of the year. It becomes crystal clear very quickly whether there are material performance issues or not.

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We now publish Five Year (four full years and recent twelve months) and Five Quarter Non-GAAP Corporate Trend Reports that track short and longer term trends in revenue, profits and profit margins by numerous categories as well as three overhead categories that are the most transparent of any we have ever seen in any company in any industry. In other words, there is no place to hide weak performance, forcing us to get better at producing sustained high operating and financial performance over time.

In my 2015 Shareholder Letter, I covered the four full financial performance years since 2011 of the value creation dynamics of our five Field EBITDA categories as well as the value creation leveraging of our consolidation platform, overhead, capital structure and Free Cash Flow capital allocation. We also publish quarterly an updated Company and Investment Profile that has a comprehensive explanation of the concept of our Trend Reports.

We had established an in-house group of operational and financial planning data analysts in June 2006 (starting with Peggy Schappaugh) who are assigned by region and business to assist and support each Managing Partner for increasing Standards Achievement over time. If any of you ever wonder what Carriage is all about operationally or about any business, just call Peggy or one of our other analysts. That's what I do.

Our first quarter 2007 earnings release and bullish outlook for 2007 under our new Trend Reports (our share price surged above \$7 per share) led to a congratulatory call from the principal of the private equity firm. When asked what price it would take to acquire Carriage, I said our future has never been brighter and is priceless. And that was that.

### **2008/2009 Market Crash to CSV's November 4th, 2011 GTG Transition Date**

Our share price peaked briefly over \$10 per share in October 2007 as our performance continued to surprise on the upside, then began a long decline as the preliminary symptoms of The Great Recession and market panic and crash in the last half of 2008 and first half of 2009 began to show themselves. First there was Bear Stearns in March 2008, volatility (especially in financial sector), liquidity and leverage issues in investment bank affiliated Structured Investment Vehicles (SIV's), etc. Then in September 2008 we had the failure of Lehman Brothers, sale of Merrill Lynch to Bank of America, AIG bailout, etc., and the panic and crash was off to the races.

I had been studying various investment concepts, methodologies and icons since the "Black Monday" crash (Dow declined 22.6%) on October 19, 1987. However, I had focused deeply and intensely over the last fifteen years on learning from the profoundly simple yet clear investing concepts of Warren Buffett and Charlie Munger. My favorite book for learning about investing and human nature (joined at the hip) is ***Seeking Wisdom, From Darwin to Munger*** by Peter Bevelin, published in 2003. I highly recommend this amazingly wonderful book to anyone wanting to be a better investor and live a better life.

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In early September, 2008 I promoted several other leaders to head operations, finance and our acquisition program while I began to focus almost entirely on our outsourced trust fund investments, which had returns historically that were acceptable and in-line with market returns. But after a deep dive into the asset allocations and very large number of intermediate sector funds in which we were invested, I concluded we had become so diversified that we were essentially “diworsified” and ill-prepared for a liquidity and credit starved market crash driven by irrational fears of nationalization of our “Too Big To Fail” banks and insurance companies.

### **Never Waste A Once In A Lifetime Market Crash And Panic**

We took control of our trust funds on October 14, 2008 and executed a complete repositioning strategy over the next eighteen months focused on individual security selection with a large concentration in the TARP pari passu preferred stocks of “Too Big To Fail” financials (cents on the dollar – apparently we were “the market”). Consequently we were able to emerge from the market crash with trust funds that were hugely overfunded and had large recurring income from our fixed income portfolio (financial preferred stock and high yield notes).

Since October 2008 we have developed an in-house team of professionals under the leadership of Ben Brink to manage our trust assets. Over the past eight years we have continued to execute a strategy of individual company and security selection geared toward high yield fixed income securities and large market capitalization stocks. Given the long term nature of preneed contract liabilities and the permanent nature of the capital, we have the ability to take a long term and patient view of our investments and be most active in the portfolio at times of market distress and dislocation (i.e. Be Greedy when others are Fearful).

We view the permanent nature of this capital and the long term liabilities of preneed contracts as an important competitive investing advantage since we have no concerns about a sudden outflow of funds from our portfolio during times of market distress, nor do we feel the pressure to make short term decisions in order to beat a benchmark performance index. We believe that the permanent nature of the preneed trust funds has enabled us to remain patient, diligent yet opportunistic for occasional portfolio repositionings for better relative value opportunities. We believe our trust fund performance management strategy and methodology will lead to continued long term success of our trust fund investments.

Since the financial crisis we have had several other significant opportunities to reposition the portfolio for long term success. The two most significant timeframe opportunities were the six to nine months after S&P downgraded the Triple A credit rating of the United States on August 5, 2011, and most recently in the fourth quarter of 2015 through the first quarter of 2016 when the energy markets plummeted (oil price hit \$26 per barrel before rebounding), triggering substantial declines and volatility in most other equity and fixed income sectors as well.

Both of these time periods gave us the opportunity to upgrade the credit quality of our large fixed income portfolio allocation at prices less than par, thereby positioning our trust funds for future capital gains while simultaneously increasing our recurring annual income. Since Carriage assumed responsibility for managing our trust funds in October 2008, the average annual return has been approximately 18%. We have recognized \$108 million in capital gains net of fees and increased the recurring Financial Revenue as reported in our Trend Reports by 82% since 2009.

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We view the in-house management of our trust funds as an integral part of our **Mission of Being The Best** and a critical support service for enhancing operating financial revenue for our Managing Partners and their operating businesses toward the goal of higher Standards Achievement over time. Our long term investing track record is confirmation that we are performing at a high level that is in complete alignment with the high operating and financial performance history of our operating portfolio of businesses.

### **Capital Allocation – CSV Shares As A Being The Best Investment**

One of the best ways for Carriage to allocate capital to maximize the intrinsic value per share for the benefit of long term shareholders is to acquire CSV shares when we believe Mr. Market is selling our shares for less than their intrinsic value. We are completely opportunistic in our approach, meaning that we will be a buyer if the current price of our shares appears to materially discount the five year “Roughly Right Scenario” of our future performance as we execute our Standards Operating, 4E Leadership and Strategic Acquisition Models.

Over the past eight years we have executed three share repurchase programs, all of which occurred at times our company was getting better faster but Mr. Market had a relatively low priced opinion of our progress. Shown below are the total returns of these three repurchases excluding dividends calculated through year end 2016.

1. Second Quarter 2008 – Fourth Quarter 2009: 3.1 million shares purchased for \$10 million at an average purchase price of \$3.22 equal to a 789% total return.
2. Fourth Quarter 2011 – Second Quarter 2012: 800,000 shares purchased for \$5.3 million at an average purchase price of \$6.48 equal to a 342% total return.
3. Second Quarter 2015 – Fourth Quarter 2015: 1.9 million shares purchased for \$45 million at an average purchase price of \$23.34 equal to a 23% total return.

By far my favorite repurchase program was during the bottoming phase of the market crash and panic from November 2008 through March 2009. I remember three notable “data points”. First, the relationship partner from our accounting firm at the time came for an emergency visit early in 2009 advising us that we should perform a rigorous funeral portfolio performance analysis for a potential goodwill impairment write-down because “the market” (CSV about \$2 per share) was saying all our funeral goodwill was worthless!

Second, I got accused on our 2008 full year performance conference call in late January 2009 of “driving the company over a cliff” because we were not hoarding cash! And Moody’s added a final indignity by downgrading Carriage’s “liquidity rating”, a rating I didn’t even know we had (Bank of America was in our bank syndicate)!

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What we were experiencing in Carriage's real high performance world during this period was the polar opposite of the "freaked out" reactions above (and many others including our Board at the time). We had no borrowings under our Revolving Bank Credit and our Tides Securities and high yield notes had long maturities, i.e. we faced no refinancing issue until early 2015, six years in the future. And profoundly, the operating performance of both our funeral and cemetery portfolios achieved records in the first half of 2009. Cash equity in the form of Free Cash Flow was gushing out everywhere! We just love trading with Mr. Market when he is panicked, depressed and acting as if the world is coming to an end!

Allocation of our Free Cash Flow toward share repurchases will only occur when there is no other use of our capital with a higher return on invested capital with any certainty over the next five to ten years. However, the tremendous growth in Free Cash Flow over the last five years does not mean that other capital allocation uses such as growth capital expenditures or acquisitions would be mutually exclusive when we are repurchasing our own shares. We will always retain the financial flexibility necessary to execute opportunistic share repurchases of our company because we are what we know best.

### **Wrong People Off The Bus, Right People In Right Seats On The Bus**

During 2010 and 2011 our operating performance trends began to deteriorate under the senior leadership at the time. It became obvious that there was broad frustration yet large, unleashed leadership performance potential across our portfolio of operating businesses.

In mid-November of 2011 after a major management reorganization on November 4, 2011, which we now refer to as our **Good To Great Transition Date**, we convened a large group of senior leaders and field operating and Houston support personnel to discuss whether the high performance ideas and concepts related to our Standards Operating Model had evolved over the prior eight years to a degree that could define Carriage as a "**Good Company**" if led and executed well by our operating leadership at all levels. In preparation for this strategic meeting on **Carriage's Ten Year Vision**, we all had to read the bestselling business book **Good To Great** by Jim Collins which was published in 2001.

There was a unanimous and exciting view at this meeting that we had indeed reached an early phase of "**Good Company**" and that our Managing Partners, Sales Managers and employees across our portfolio of businesses would be inspired to achieve higher levels of sustained operating and financial performance by the launching of a five year **Good To Great Journey** beginning in 2012 in combination with a new long term (five year) **Good To Great** value creation incentive program to complement our annual **Being The Best Pinnacle of Service Award**.

Accordingly, we established and then communicated companywide extraordinarily challenging goals over the five year timeframe beginning in 2012 and ending with 2016 consistent with the five year theme of taking Carriage from a **Good** company in 2012 to one considered **Great** by 2016 based on total equity market value growth and total shareholder returns over time.

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Despite the dynamic and transformational changes in all areas of our company over the past five years, including the turnover, shrinkage and improved alignment of our senior leadership team and Board of Directors, a much lower cost capital structure, and the huge growth in our earning power and equity market value, we nevertheless realized over the last two years that the **Good To Great Journey** should not cross some artificial finish line at the end of 2016.

Instead, we concluded that such a special journey of learning among likeminded individuals in a quest for excellence should never end because there are still so many ways we can get better in every operational and support function area of our company. Our thinking now is that every time we might cross a high performance threshold of “goodness” and are approaching “great”, we will redefine what greatness means for our company and industry and simply continue our **Good To Great Journey** that never ends.

## **Reflections and Acknowledgements**

Reflecting back on the learning journey of our first 25 years, including 2016 and the beginning of 2017, I would like to acknowledge and thank a few people who have made a meaningful and lasting difference, especially in my thinking about important matters at important times:

First, Bob Waltrip, Founder, Pioneering Visionary and Chairman Emeritus of SCI, with whom I developed a special personal relationship over the years (survivor bonding!), especially after our sector crashed in 1999. Bob was the first to call to congratulate and thank me when we refinanced our remaining crisis era bank borrowings in the summer of 2003 (SCI received \$5 million for 100% repayment of it's written off Provident loans). That meant a lot to me then and even more now.

Dick Strong, who took an interest in Carriage during the late 1990s as a growth stock portfolio holding in Strong Capital Management in Milwaukee. For years after the 1999 deathcare sector crash, Dick would visit me in Houston with encouragement and wise counsel that the toughest decisions can be made when expectations are the lowest and no one cares.

Without exception on each visit Dick would ask, “Mel, how many A Players do you have?” My favorite memory of this period was knowing Dick would ask the question on each visit and admitting over the next several years that the number of A Players in Carriage actually declined dramatically as I became better calibrated on how to define A Player performance. Dick, thank you for caring when no one else did and making a difference.

Peter Badger, a dear friend since 1987 and historically one of Houston's top mortgage securities traders and brokers, who became my daily “foxhole buddy” for over two years as we executed our trust fund repositioning strategy starting in October 2008. Peter would wander into the over-the-counter “fixed income securities for sale wilderness” each morning and develop a daily Carriage “shopping list” with ask prices by 10:00 AM of securities that fit the profile we were seeking to buy.

I thought the ask prices in most cases were “too good to be true” from October 2008 through 2010 but Peter never failed to get lower “bid prices” executed. It only occurred to me later that we were often “the market”, i.e. there was no other price discovery because there were no other buyers, only sellers! Those were the good old days for sinful investment returns! Thank you Peter for this once in a lifetime investing adventure and journey together.



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Bill Heiligbrodt (2009-2016) and Dave DeCarlo (2011-2016) for their contributions as Board Members as well as Executive Officers of Carriage during a critical transitional timeframe for our company.

Alan Weber, a long time shareholder who has provided encouragement and analytical relative returns investment counsel when I needed it most, especially in November 2008 when our Board would not initially support my plan to repurchase our shares during the bottoming phase of the market crash and panic. Alan also introduced me to the wonderful book ***The Outsiders***, authored by Will Thorndike and published in 2012. ***The Outsiders*** featured chapters on eight legendary CEOs (Warren Buffett, Tom Murphy and Dan Burke, John Malone, Henry Singleton, etc.) who mastered capital allocation and thereby created outsized returns for their respective companies and shareowners over many decades.

I was able to meet Will this past year and subsequently host him as a special guest at our February 2017 Board Dinner and Meeting. Will's work and analysis on the importance of capital allocation for "Compounder Companies" led us to incorporate "Capital Allocation" into the Visual Schematic of our High Performance Culture Framework in early 2015, forever making wise capital allocation a core part of our high performance culture DNA. Thank you Will.

Alan Weber and Will Thorndike again for pointing me and my senior leadership team to the study of other companies from which we can learn much about capital allocation and value creation. Two of these unique companies have been Credit Acceptance and Constellation Software, led by CEO's Brett Roberts and Mark Leonard, respectively, whose shareholder letters have been not only educational but inspirational.

Lastly, I would like to acknowledge and thank Jim Collins, whom I have never met, for the groundbreaking research that he and his team did for ***Good To Great***, whose simple yet powerful high performance ideas and concepts have inspired me and our leaders and employees over the last five years.

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## Final Observations About The Past and Present

To conclude this Shareholder Letter, I will share a few observations and conclusions about human nature and the nature of our markets as well as what I believe to be the current state of the nature of Carriage.

- It is very difficult for most people (even some very smart ones) to think about something in a completely new, unorthodox, counterintuitive and unconventional way – which makes the uniqueness of Carriage as it has evolved pretty cool for those who “get to the other side!”
- Our small market capitalization size is a large hurdle to overcome with many institutional investors who perceive our small size as riskier and/or need to invest much larger pools of capital than the liquidity of our outstanding shares can accommodate, but we have learned to live with this frustration and focus only on maximizing the compounding of the intrinsic value of each of our shares over five to ten year timeframes into a “coulda, woulda, shoulda bought that” share price!
- Our organizational framework is designed around the idea of partnership. Our three models and high performance culture ideas and concepts as they have evolved over the last thirteen years have turned the classic methodology of consolidation upside down and made the most important jobs in the company those of our Managing Partners at the local business level rather than up the chain of command.
- The high performance culture ideas and concepts of Carriage as they have been implemented and evolved have dramatically flattened our organizational structure; eliminated numerous bureaucratic layers and the associated politics, perks and meaningless titles; simplified and eliminated in many cases the complexity of burdensome reporting, policies and procedures; and eliminated endless corporate process oriented initiatives - all characteristics that creep into most companies as they grow through a succession of enterprise leaders over time.
- Our High Performance Culture Framework is more cost effective organizationally, as the corporate organizational overhead does not “eat up” a substantial amount of the incremental financial performance of our field businesses, especially as we leverage our consolidation platform with growth by highly selective acquisitions, enabling more of the value creation to be shared with both those who create it locally and with public shareholders.
- The best remaining family owned funeral home and cemetery business franchises in the best markets will absolutely get better over time after full integration into our **Being The Best** framework of operations support.
- The innovation, evolution and application of our Standards Operating Model and High Performance Culture Framework for operating and consolidating the funeral and cemetery industry is akin to intellectual property that was developed over the last thirteen years which forms a “protective cultural moat” around Carriage’s earning power.
- Curious and disappointed why no one has challenged our contention that Carriage’s 29.7% Adjusted Consolidated EBITDA Margin in 2016 is not only a company but an industry milestone that has never been achieved. But even more profoundly, does anyone wonder, “What Does It Mean?”



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- Intrigued why no one has had the curiosity to ask us about the book ***Beyond Budgeting*** co-authored and published in 2003 by Robin Frazer and Jeremy Hope or about their article “Who Needs Budgets” published in the February 2003 edition of Harvard Business Review. But really fascinated that the ideas and concepts they researched on a “radically decentralized” business model have gone nowhere fast in “Corporate America” over the last fourteen years.
  - Fascinated to learn about and read ***The Evolution of Cooperation***, authored by Robert Axelrod and published in 1984, from a recommendation in Mark Leonard’s 2014 Constellation Software Shareholder Letter, a book he said changed his thinking on important business matters. After reading this book and a subsequent one titled ***Harnessing Complexity*** with the subtitle ***Organizational Implications of a Scientific Frontier***, co-authored by Robert Axelrod and Michael D. Cohen in 2000, I would postulate (maybe not so humbly) that Carriage has evolved into a rather advanced state of “harnessing the high performance complexity” of successfully operating and consolidating the highly fragmented funeral and cemetery industry for the huge benefit over time of long term shareowners.

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## **The Future**

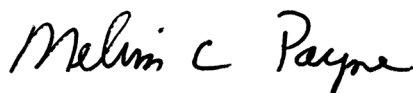
Our long term future has never been as visible and bright as it is right now. But the best part is that we have a company full of leaders and employees who envision the future just as optimistically as I do and are perfectly aligned to execute their “Flywheel Effect” roles and responsibilities to make it happen. We are in a very good place in our company and in our industry as we enter the second five year timeframe of **Carriage’s Good To Great Journey** that never ends.

As I have done each year since 2012 with my annual theme letter to all employees to start off our year, I leave you with this final thought:

**“Greatness is not a function of circumstance. Greatness, it turns out, is largely a matter of conscious choice!”<sup>2</sup>**

**We Choose Greatness.**

Respectfully,



**Melvin C. Payne**  
Chairman and Chief Executive Officer

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## **CARRIAGE 2016 GOOD TO GREAT AWARD HIGH PERFORMANCE HEROES**

At the beginning of 2012 we created a new five year incentive award with the name **Good To Great Award** that was directly linked to our annual **Being The Best Pinnacle Award** which itself is linked to High Funeral Standards Achievement over a full year, i.e. our **Good To Great Awards** require high and sustained **Being The Best Standards Achievement** over the full five years. We have had many wonderful performances over the last five years by High Performance Hero Funeral and Cemetery Managing Partners and Sales Managers and their teams of winning employees, so I am more than honored on behalf of our Standards Council members, senior leadership team and Board of Directors to announce our first **Good To Great Award** winners for the five year timeframe that began in 2012 and ended at year-end 2016, as listed below:

Kristi Ah You	Franklin & Downs Funeral Home; Modesto, CA
James Bass	Twin Cities Cremation Services and Funeral Home; Niceville, FL; and Emerald Coast Funeral Home/McLaughlin Mortuary; Fort Walton Beach
Kyle Incardona	Hillier Funeral Homes; Bryan, TX
Steve Mora	Conejo Mountain Funeral Home; Camarillo, CA
Ken Summers	P.L. Fry & Son Funeral Home; Manteca, CA
Robert Maclary	Kent-Forest Lawn Funeral Home; Panama City, FL
Chad Woody	Watson-King Funeral Homes; Rockingham, NC
Brad Shemwell	Latham Funeral Home; Elkton, KY
Michael Page	Allison Funeral Home; Liberty, TX
Patty Drake	Drake Whaley McCarty Funeral Home; Cynthiana, KY
Andy Shemwell	Maddux-Fuqua-Hinton Funeral Homes, Hopkinsville, KY
Tim Hauck	Cape Coral Group; Cape Coral, FL

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## CARRIAGE 2016 BEING THE BEST / PINNACLE OF SERVICE AWARD WINNERS

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As an important part of our High Performance Culture tradition and language, and because we have a passionate conviction that RECOGNITION is the highest form of motivation, listed below are thirty-five **Carriage Being The Best Pinnacle of Service Award** winners for 2016:

James Terry	James I. Terry Funeral Home; Downingtown, PA
James Bass	Twin Cities Cremation Services and Funeral Home; Niceville, FL; and Emerald Coast Funeral Home/McLaughlin Mortuary; Fort Walton Beach
Bill Martinez	Stanfill Funeral Home; Miami, FL
Richard Munoz	Connolly & Taylor Funeral Directors; Martinez, CA
Benjamin Friberg	Heritage Funeral Home and Crematory; Ft. Oglethorpe, GA
Brad Shemwell	Latham Funeral Home; Elkton, KY
Joseph Waterwash	Baird-Case Jordan-Fannin Funeral Home & Cremation Service; Ft. Lauderdale, FL
Jason Higginbotham	Lakeland Funeral Home; Lakeland, FL
Jeff Moore	Sterling-White Funeral Home; Crosby, TX
Kristi Ah You	Franklin & Downs Funeral Home; Modesto, CA
Kyle Incardona	Hillier Funeral Homes; Bryan, TX
Jason Cox	Lane Funeral Home – South Crest Chapel; Rossville, GA
Michael Nicosia	Chapel of San Ramon Valley; Danville, CA and Quimet Brothers Concord Funeral Directors; Concord, CA
Robert Maclary	Kent-Forest Lawn Funeral Home; Panama City, FL
Tim Hauck	Cape Coral Group; Cape Coral, FL
Andrew Cumby	Cumby Family Funeral Homes; High Point, NC
Chris Duhaime	Funk Funeral Home; Bristol, CT
Chris Chetsas	Cataudella Funeral Home; Methuen, MA
John Fitzpatrick	Donohue Cecere Funeral Directors; Westbury, NY
Chad Woody	Watson-King Funeral Homes; Rockingham, NC
Ken Summers	P.L. Fry & Son Funeral Home; Manteca, CA
Matthew Simpson	Fry Memorial Chapel; Tracy, CA
Justin Luyben	Evans-Brown Mortuaries & Crematory; Sun City, CA
Curtis Ottinger	Heritage Funeral Home; Chattanooga, TN
Verdo Were	McNary-Moore Funeral Service; Colusa, CA
Andy Shemwell	Maddux-Fuqua-Hinton Funeral Homes, Hopkinsville, KY
Steve Mora	Conejo Mountain Funeral Home; Camarillo, CA
Patty Drake	Drake Whaley McCarty Funeral Home; Cynthiana, KY
Brian Binion	Steen Funeral Homes; Ashland, KY
Roger Allen	LaGrone-Blackburn-Shaw Funeral Directors; Amarillo, TX
Jeff Seaman	Dwayne R. Spence Funeral Home; Canal Winchester, OH
Ashley Vella	Deegan Funeral Chapels; Escalon, CA
Mike Conner	Conner-Westbury Funeral Home; Griffin, CA
Tim Miller	Fuller Funeral Home & Cremation Service (East); Naples, FL
Kim Borselli	Fuller Funeral Home & Cremation Service (Pine Ridge); Naples, FL

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## High Performance Culture Framework

### CARRIAGE SERVICES, INC. “BEING THE BEST”

Funeral and Cemetery Operating Company  
Consolidator Of Independent Family Businesses  
Value Creation Investment Platform

### Five Guiding Principles

Honesty, Integrity, and Quality in All That We Do  
Hard Work, Pride of Accomplishment, and Shared Success Through Employee Ownership  
Belief in the Power of People Through Individual Initiative and Teamwork  
Outstanding Service and Profitability Go Hand-in-Hand  
Growth of the Company Is Driven by Decentralization and Partnership

### Concepts of Good To Great

First Who, Then What  
Right People in the Right Seats  
*Flywheel Effect*

#### Standards Operating Model

Market Share  
People  
Operating & Financial Metrics

Integrity

#### 4E Leadership Model

Energy  
Energize  
Edge  
Execution

Passion

#### Strategic Acquisition Model

Ten Year Vision  
Strategic Markets  
Strategic Market Methodology  
Selective Growth Strategy

Being The Best League Table  
Being The Best Annual Incentive  
Good To Great Five Year Incentive

High Standards Achievement

#### Capital Allocation

Acquisitions  
Internal Growth Projects  
Share Repurchases  
Dividends  
Debt Repayment

Valuation Ranking Methodology

ROIC & LOI Methodology

Maximize Intrinsic Shareholder Value Per Share

#### Value Creation Financial Dynamics

Operating Leverage  
Overhead Leverage  
Capital Structure Leverage  
Consolidation Platform Leverage

Five Year Trend Reports

Sustained High Financial Performance

**Carriage Journey From Good To Great**  
**Carriage Achieves High Valuation**  
**Carriage Becomes Built To Last**

# ANNUAL OPERATING AND FINANCIAL TREND REPORT

This table uses Non-GAAP financial measures to present the financial performance of the Company. Non-GAAP financial measures should be viewed in addition to, and not as an alternative for, the Company's reported operating results or cash flow from operations or any other measure of performance as determined in accordance with GAAP. We believe the Non-GAAP results are useful to investors because such results help investors compare our results to previous periods and provide insights into underlying trends in our business. In addition, the Company's presentation of these measures may not be comparable to similarly titled measures in other companies' reports. The Non-GAAP financial measures include "Funeral, Cemetery and Financial EBITDA", "Total Field EBITDA", "Total Field EBITDA Margin", "Consolidated EBITDA", "Adjusted Consolidated EBITDA", "Adjusted Consolidated EBITDA Margin", "Adjusted Net Income", "Adjusted Basic Earnings Per Share", "Adjusted Diluted Earnings Per Share" and "Total Special Items, Net of tax". A full copy of our Annual Operating and Financial Trend Report and reconciliations of the Non-GAAP financial measures to GAAP measures are provided on our website, [www.carriageservices.com](http://www.carriageservices.com).

(in thousands, except per share amounts)

	2011	2012	2013	2014	2015	2016	CAGR
<b>Same Store Contracts</b>							
Atneed Contracts	20,717	21,555	21,515	21,648	21,802	21,428	
Preneed Contracts	5,528	5,436	5,585	5,271	5,346	5,208	
Total Same Store Funeral Contracts	26,245	26,991	27,100	26,919	27,148	26,636	0.3%
<b>Acquisition Contracts</b>							
Atneed Contracts	n/a	815	2,323	3,745	4,497	5,555	
Preneed Contracts	n/a	58	431	738	982	969	
Total Acquisition Funeral Contracts	n/a	873	2,754	4,483	5,479	6,524	
<b>Total Funeral Contracts</b>	<b>26,245</b>	<b>27,864</b>	<b>29,854</b>	<b>31,402</b>	<b>32,627</b>	<b>33,160</b>	<b>4.8%</b>
<b>Funeral Operating Revenue</b>							
Same Store Revenue	\$131,859	\$138,547	\$138,606	\$138,639	\$142,690	\$140,459	1.3%
Acquisition Revenue	n/a	4,662	15,245	25,613	33,678	40,165	
Total Funeral Operating Revenue	\$131,859	\$143,208	\$153,851	\$164,252	\$176,368	\$180,624	6.5%
<b>Cemetery Operating Revenue</b>							
Same Store Revenue	\$36,481	\$38,113	\$40,181	\$41,257	\$43,336	\$45,441	4.5%
Acquisition Revenue	n/a	166	298	1,599	3,321	3,506	
Total Cemetery Operating Revenue	\$36,481	\$38,279	\$40,479	\$42,856	\$46,657	\$48,947	6.1%
Total Financial Revenue	\$13,973	\$16,704	\$18,744	\$19,016	\$19,477	\$18,629	5.9%
<b>Total Revenue</b>	<b>\$182,313</b>	<b>\$198,191</b>	<b>\$213,074</b>	<b>\$226,124</b>	<b>\$242,502</b>	<b>\$248,200</b>	<b>6.4%</b>
<b>Field EBITDA</b>							
Same Store Funeral Field EBITDA	\$46,093	\$52,043	\$50,674	\$50,986	\$54,620	\$54,706	3.5%
Same Store Funeral Field EBITDA Margin	35.0%	37.6%	36.6%	36.8%	38.3%	38.9%	
Acquisition Funeral Field EBITDA	n/a	1,510	4,785	9,488	13,693	16,536	
Acquisition Funeral Field EBITDA Margin	0.0%	32.4%	31.4%	37.0%	40.7%	41.2%	
Total Funeral Field EBITDA	\$46,093	\$53,553	\$55,459	\$60,474	\$68,313	\$71,242	9.1%
Total Funeral Field EBITDA Margin	35.0%	37.4%	36.0%	36.8%	38.7%	39.4%	
Same Store Cemetery Field EBITDA	\$9,370	\$9,897	\$11,757	\$11,845	\$14,045	\$14,499	9.1%
Same Store Cemetery Field EBITDA Margin	25.7%	26.0%	29.3%	28.7%	32.4%	31.9%	
Acquired Cemetery Field EBITDA	n/a	(76)	(43)	351	1,088	1,168	
Acquired Cemetery Field EBITDA Margin	0.0%	(45.8)%	(14.4)%	22.0%	32.8%	33.3%	
Total Cemetery Field EBITDA	\$9,370	\$9,821	\$11,714	\$12,196	\$15,133	\$15,667	10.8%
Total Cemetery Field EBITDA Margin	25.7%	25.7%	28.9%	28.5%	32.4%	32.0%	
Total Financial EBITDA	\$12,602	\$15,255	\$17,304	\$17,689	\$18,093	\$17,504	6.8%
Total Financial EBITDA Margin	90.2%	91.3%	92.3%	93.0%	92.9%	94.0%	
Total Field EBITDA	\$68,065	\$78,629	\$84,477	\$90,359	\$101,539	\$104,413	8.9%
Total Field EBITDA Margin	37.3%	39.7%	39.6%	40.0%	41.9%	42.1%	
Total Overhead	\$28,886	\$30,272	\$33,020	\$34,127	\$34,667	\$35,898	4.4%
Overhead as a percentage of Revenue	15.8%	15.3%	15.5%	15.1%	14.3%	14.5%	
Consolidated EBITDA	\$39,179	\$48,357	\$51,457	\$56,232	\$66,872	\$68,515	11.8%
Consolidated EBITDA Margin	21.5%	24.4%	24.1%	24.9%	27.6%	27.6%	
Other Expenses and Interest							
Depreciation & Amortization	\$9,450	\$9,916	\$11,635	\$11,923	\$13,780	\$15,421	
Non-Cash Stock Compensation	1,870	2,174	2,916	3,832	4,444	2,890	
Interest Expense	18,089	17,088	13,437	10,308	10,559	11,738	
Accretion of Discount on Convert. Sub. Notes	-	-	-	2,452	3,454	3,870	
Loss on Early Extinguishment of Debt	201	3,031	-	1,042	-	567	
Loss on Redemption of Convert. Jr. Sub. Deb.	-	-	-	3,779	-	-	
Other, Net	(898)	(963)	(896)	195	45	1,788	
Pretax Income	\$10,467	\$17,111	\$24,365	\$22,701	\$34,590	\$32,241	25.2%
Net Tax Provision	4,448	6,794	9,245	7,255	13,737	12,660	23.3%
<b>GAAP Net Income</b>	<b>\$6,019</b>	<b>\$10,317</b>	<b>\$15,120</b>	<b>\$15,446</b>	<b>\$20,853</b>	<b>\$19,581</b>	<b>26.6%</b>
Total Special Items, Net of tax	\$5,776	\$4,213	\$2,973	\$9,348	\$6,508	\$8,757	
<b>Adjusted Net Income</b>	<b>\$11,795</b>	<b>\$14,530</b>	<b>\$18,093</b>	<b>\$24,794</b>	<b>\$27,361</b>	<b>\$28,338</b>	<b>19.2%</b>
Adjusted Net Profit Margin	6.5%	7.3%	8.5%	11.0%	11.3%	11.4%	
Reconciliation of Consolidated EBITDA to Adjusted Consolidated EBITDA							
Consolidated EBITDA	\$39,179	\$48,357	\$51,457	\$56,232	\$66,872	\$68,515	11.8%
Total Special Items	\$9,395	\$4,253	\$4,550	\$5,421	\$4,261	\$5,176	
<b>Adjusted Consolidated EBITDA</b>	<b>\$48,574</b>	<b>\$52,610</b>	<b>\$56,007</b>	<b>\$61,653</b>	<b>\$71,133</b>	<b>\$73,691</b>	<b>8.7%</b>
Adjusted Consolidated EBITDA Margin	26.6%	26.5%	26.3%	27.3%	29.3%	29.7%	
GAAP Diluted EPS	\$0.33	\$0.57	\$0.82	\$0.83	\$1.12	\$1.12	27.9%
Adjusted Diluted EPS	\$0.64	\$0.80	\$0.98	\$1.34	\$1.48	\$1.62	20.4%
Average Number of Diluted Shares Outstanding	18,397	18,226	22,393	18,257	18,313	17,460	-1.0%
GAAP Basic EPS	\$0.33	\$0.57	\$0.83	\$0.84	\$1.16	\$1.18	29.2%
Adjusted Basic EPS	\$0.64	\$0.80	\$1.00	\$1.35	\$1.52	\$1.71	21.6%
Average Number of Basic Shares Outstanding	18,359	18,126	17,826	18,108	17,791	16,515	-2.1%

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-K**

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended, December 31, 2016**

**or**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 1-11961**

**CARRIAGE SERVICES, INC.**

**(Exact name of registrant as specified in its charter)**

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**76-0423828**

(I.R.S. Employer  
Identification No.)

**3040 Post Oak Blvd., Suite 300, Houston, Texas**

(Address of principal executive offices)

**77056**

(Zip Code)

**Registrant's telephone number, including area code: (713) 332-8400**

**Securities registered pursuant to Section 12(b) of the Act:**

(Title of each class)

Common Stock, \$.01 Par Value

(Name of each exchange on which registered)

New York Stock Exchange

**Securities registered pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes ☐ No ☒

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerator filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

☐

Accelerated filer

☒

Non-Accelerated filer

☐ (Do not check if a smaller reporting company)

Smaller Reporting Company

☐

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Securities Exchange Act of 1934. Yes ☐ No ☒

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2016 was approximately \$350.4 million based on the closing price of \$23.68 per share on the New York Stock Exchange.

The number of shares of the registrant's Common Stock, \$.01 par value per share, outstanding as of February 20, 2017 was 16,660,755.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive proxy statement for its 2017 annual meeting of stockholders, which will be filed with the Securities and Exchange Commission within 120 days of December 31, 2016, are incorporated in Part III of this Annual Report on Form 10-K.



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## CAUTIONARY NOTE

Certain statements and information in this Annual Report on Form 10-K (this “Form 10-K”) may constitute “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. The words “may,” “estimate,” “believe,” “expect,” “anticipate,” “plan,” “intend,” “foresee,” “should,” “would,” “could” or other similar expressions are intended to identify forward-looking statements, which are generally not historical in nature. These forward-looking statements include, but are not limited to, statements regarding any projections of earnings, revenues, asset sales, cash flow, debt levels or other financial items; any statements of the plans, strategies and objectives of management for future operations; any statements regarding future economic conditions or performance; any statements of belief; and any statements of assumptions underlying any of the foregoing and are based on our current expectations and beliefs concerning future developments and their potential effect on us. While management believes that these forward-looking statements are reasonable as and when made, there can be no assurance that future developments affecting us will be those that we anticipate. All comments concerning our expectations for future revenues and operating results are based on our forecasts for our existing operations and do not include the potential impact of any future acquisitions. Our forward-looking statements involve significant risks and uncertainties (some of which are beyond our control) and assumptions that could cause actual results to differ materially from our historical experience and our present expectations or projections. Important factors that could cause actual results to differ materially from those in the forward-looking statements include, but are not limited to, those summarized below:

- the ability to find and retain skilled personnel;
- our ability to execute our growth strategy;
- the effects of competition;
- the execution of our Standards Operating, 4E leadership and Standard Acquisition Models;
- changes in the number of deaths in our markets;
- changes in consumer preferences;
- our ability to generate preneed sales;
- the investment performance of our funeral and cemetery trust funds;
- fluctuations in interest rates;
- our ability to obtain debt or equity financing on satisfactory terms to fund additional acquisitions, expansion projects, working capital requirements and the repayment or refinancing of indebtedness;
- death benefits related to preneed funeral contracts funded through life insurance contracts;
- the financial condition of third-party insurance companies that fund our preneed funeral contracts;
- increased or unanticipated costs, such as insurance or taxes;
- effects of the application of applicable laws and regulations, including changes in such regulations or the interpretation thereof;
- consolidation of the funeral and cemetery industry; and
- other factors and uncertainties inherent in the funeral and cemetery industry.

For additional information regarding known material factors that could cause our actual results to differ from our projected results, please see Part I, Item 1A, Risk Factors.

Investors are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof. We undertake no obligation to publicly update or revise any forward-looking statements after the date they are made, whether as a result of new information, future events or otherwise.

## PART I

### ITEM 1. BUSINESS.

#### GENERAL

Carriage Services, Inc. (“Carriage,” the “Company,” “we,” “us,” or “our”) was incorporated in the State of Delaware in December 1993 and is a leading provider of funeral and cemetery services and merchandise in the United States. We operate in two business segments: funeral home operations, which currently account for approximately 76% of our total revenue, and cemetery operations, which currently account for approximately 24% of our total revenue.

Our funeral homes offer a complete range of services to meet a family’s deathcare needs, including consultation, the removal and preparation of remains, the sale of caskets and related funeral merchandise, the use of funeral home facilities for visitation and services and transportation services. Our cemeteries are primarily sales businesses that sell interment rights (grave sites and mausoleum spaces) and related merchandise, such as markers and outer burial containers.

At December 31, 2016, we operated 170 funeral homes in 28 states and 32 cemeteries in 11 states. We compete with other public funeral and cemetery companies and smaller, independent operators. We believe we are a market leader (first or second) in most of our markets. We provide funeral and cemetery services and products on both an “at-need” (time of death) and “preneed” (planned prior to death) basis.

#### CURRENT YEAR DEVELOPMENTS

*Acquisitions.* During 2016, we acquired six funeral home businesses. We acquired two funeral home businesses in Houston, Texas in May 2016, one funeral home business in Madera, California in September 2016, one funeral home business in Brookfield, Wisconsin in November 2016 and two funeral home businesses in Burlington, North Carolina and Graham, North Carolina in November 2016. The pro forma impact of the acquisitions on prior periods is not presented as the impact is not material to our reported results. The results of the acquired businesses are included in our results of operations from the date of acquisition.

*Credit Facility.* On February 9, 2016, we entered into a seventh amendment (the “Seventh Amendment”) to our Credit Facility. The Seventh Amendment resulted in, among other things, (i) reducing our LIBOR based variable interest rate 37.5 basis points, (ii) extending the maturity so that the Credit Agreement will mature at the earlier of (a) any date that is 91 days prior to the maturity of any subordinated debt (including the \$143.75 million in principal amount of 2.75% Convertible Subordinated Notes issued on or about March 19, 2014 and due March 15, 2021 (the “Convertible Notes”) or (b) February 9, 2021, (iii) increasing and funding the term loan so that \$150 million was outstanding upon the effectiveness of the Seventh Amendment, (iv) reducing the size of the revolver to \$150 million, (v) increasing the accordion to \$75 million and (vi) updating the amortization payments for the term loan facility so that the borrowings under the term loan facility are subject to amortization payments of (a) \$2.81 million at the end of each fiscal quarter beginning with the fiscal quarter ending March 31, 2016 through the fiscal quarter ending December 31, 2017, (b) \$3.75 million at the end of each fiscal quarter beginning with the fiscal quarter ending March 31, 2018 through the fiscal quarter ending March 31, 2020 and (c) \$4.69 million at the end of each fiscal quarter beginning with the fiscal quarter ending June 30, 2020 through the fiscal quarter ending December 31, 2020.

*Commitments.* Effective April 30, 2016, we terminated an agreement to outsource the processing of transactions for our cemetery business and certain accounting activities. At that time, all transaction processing returned in-house and we retained most of the personnel of the service provider that resided in our home office.

*Share Repurchase Program.* On February 25, 2016, our Board approved a share repurchase program authorizing us to purchase up to an aggregate of \$25.0 million of our common stock in accordance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). The shares may be purchased from time to time in the open market or in privately negotiated transactions. Purchases will be at times and in amounts as management deems appropriate based on factors such as market conditions, legal requirements and other business considerations. During the year ended December 31, 2016, we did not repurchase any shares of common stock pursuant to this share repurchase program.

*Executive Leadership Changes.* David J. DeCarlo resigned as President of the Company and Vice Chairman of the Board of Directors (our “Board”) due to his retirement, effective September 30, 2016. As a result, the total size of the Board decreased from six to five members.

*Board Of Directors.* On August 9, 2016, Richard W. Scott resigned from the Board. At the time of his resignation, Mr. Scott was serving as the chairman of the Corporate Governance Committee and a member of the Audit and Compensation Committees. On the same day, the Board voted James R. Schenck to serve as a Class 1 Director until the 2018 annual meeting of shareholders.

*Dividends.* On May 19, 2016, the Board approved an increase in our quarterly cash dividend on our common stock from \$0.025 to \$0.05 per share, effective with respect to dividends payable on September 1, 2016 and later. For our 2016 fiscal year, we paid approximately \$2.5 million in dividends.

## **FUNERAL AND CEMETERY INDUSTRY**

Funeral home and cemetery businesses provide products and services to families in three principal areas: (i) ceremony and tribute, generally in the form of a funeral or memorial service; (ii) disposition of remains, either through burial or cremation; and (iii) memorialization, generally through monuments, markers or inscriptions. The funeral and cemetery industry in the United States is characterized by the following fundamental attributes (the industry statistics and information included in this Form 10-K are from reports compiled by Sundale Research based on information as of September 30, 2016 from the U.S. Department of Commerce).

### ***Deaths and Death Trends***

During 2016, the number of deaths in the United States increased by approximately 1.3% following a 1.9% and a 1.1% increase in 2015 and 2014, respectively. The rapidly growing and aging population (more than half of the U.S. population will be over the age of 50 within the next five years), is expected to result in an increase in the number of deaths annually. The number of Americans age 65 and over is expected to increase from 46.8 million in 2015 to 54.1 million in 2020, reflecting an average annual growth rate of 2.9%. Overall, the number of deaths in the United States is expected to increase by an average of 1.6% per year reaching an estimated 2.9 million in 2020.

### ***Burial and Cremation Trends***

While the number of deaths is expected to increase over the next few years, the burial rate is expected to continue to decline, however, the cremation rate is expected to continue to increase. In 2016, the number of burials in the United States decreased by an estimated 1.3%, following declines of 1.2% and 1.5% in 2015 and 2014, respectively. The number of burials in the United States is estimated to fall by an average of 1.1% per year from 2015 through 2020, as the burial rate is expected to decrease by more than six percentage points during this time. In 2016, the burial rate was estimated to be 50.4% and is estimated to fall to 45.1% in 2020. It is estimated that there will be approximately 1.31 million burials in 2020 declining from 1.36 million in 2016.

In 2016, the number of cremations in the United States increased by an estimated 3.9%, following increases of 5.3% and 4.4% in 2015 and 2014, respectively. Slower growth is expected through 2020, due in part to the sheer size of the market for cremations; however, shifting preferences will continue to lead to a considerable rise in cremations. The number of cremations in the United States is expected to grow by an average of 4.3% per year through 2020. In 2020, it is estimated that there will be approximately 1.59 million cremations in the United States and a cremation rate of 54.9%.

### ***Highly Fragmented Ownership***

Our industry, after over 50 years of consolidation, remains highly fragmented, and succession planning issues for privately-owned funeral and cemetery businesses have become more difficult and complex than ever. We believe Carriage provides a unique consolidation and operating framework that offers a highly attractive succession planning solution for owners who want their legacy family business to remain operationally prosperous in their local communities. We also believe that our decentralized operating model will continue to attract the top entrepreneurial talent in our industry. Our focus is on partnering with the best of the remaining independent funeral home and cemetery owners in major strategic markets around the country where the potential for future revenue growth is the highest.

The largest public operators, in terms of revenue, of both funeral homes and cemeteries in the United States are Service Corporation International (“SCI”), StoneMor Partners L.P. (“StoneMor”) and Carriage. We believe these three companies collectively represent approximately 20% of funeral and cemetery revenues in the United States. Independent businesses, along with a few privately-owned consolidators, represent the remaining amount of industry revenue, accounting for an estimated 80% share of revenues.

### ***Heritage and Tradition***

Funeral home and cemetery businesses have traditionally been family-owned businesses that have built a local heritage and tradition through successive generations, providing a foundation for ongoing business opportunities from established client family relationships and related referrals. Given the sensitive nature of our business, we believe that relationships fostered at the local level build trust in the community and are a key driver of market share. While new entrants may enter any given market, the time and resources required to develop local heritage and tradition serve as important barriers to entry.

## BUSINESS STRATEGY

Our business strategy is based on strong, local leadership and entrepreneurial principles that we believe drive market share, revenue growth, and profitability in our local markets. We believe Carriage has the most innovative and transparent operating and reporting processes in the funeral and cemetery industry, which we are able to achieve through a decentralized, high-performance cultural operating framework linked with incentive compensation programs that attract top-quality industry talent at all levels.

We are defined by our **Mission Statement** which states that “we are committed to being the most professional, ethical and highest quality funeral and cemetery service organization in our industry” and our **Guiding Principles** which state our core values, which are comprised of:

- honesty, integrity and quality in all that we do;
- hard work, pride of accomplishment and shared success through employee ownership;
- belief in the power of people through individual initiative and teamwork;
- outstanding service and profitability go hand-in-hand; and
- growth of the Company is driven by decentralization and partnership.

Our five **Guiding Principles** collectively embody our **Being The Best** high-performance cultural, operating framework. Our general operations and business strategy are built upon the execution of the following three models:

- Standards Operating Model;
- 4E Leadership Model; and
- Strategic Acquisition Model.

### *Standards Operating Model*

Our Standards Operating Model eliminates the use of financial budgets which creates enormous amounts of time to focus and work on growing each local business and improving the quality and skills of the staff. Instead of the budget and control model, our Standards Operating Model and the underlying Standards which we refer to as “**Being The Best**,” focus on market share, people, and operating and financial metrics that drive long-term, sustainable revenue growth and earning power of our portfolio of businesses by employing leadership and entrepreneurial principles that fit the nature of our local, personal service, high-value business. Standards Achievement is the measure by which we judge the success of each business and incentivize our local managers and their teams. Our Standards Operating Model is not designed to produce maximum short-term earnings because we do not believe such performance is sustainable and will ultimately stress the business, which very often leads to declining market share, revenues and earnings.

Important elements of our Standards Operating Model include:

- *Balanced Operating Model* – We believe a decentralized structure works best in the funeral and cemetery industry. Successful execution of our Standards Operating Model is highly dependent on strong local leadership, intelligent risk taking, entrepreneurial drive and corporate support aligned with the key drivers of a successful operation organized around three primary areas - market share, people and operating financial metrics.
- *Incentives Aligned with Standards* – Empowering local managers, which we call Managing Partners, to do the right things in their operations and local communities, and providing appropriate support with operating and financial practices, will enable long-term growth and sustainable profitability. Each Managing Partner participates in a variable bonus plan whereby he or she earns a percentage of his or her respective business' earnings based upon the actual standards achieved as long as the performance exceeds our minimum standards. In 2012, we began a five year incentive plan, called “**Good to Great**,” which rewards Managing Partners with a bonus at the end of five years, equal to a ratio of four to six times their average annual bonus, if they are able to achieve an annual compound growth rate of 2% over a five year period. After each five year incentive plan is achieved and paid out, a new five year plan begins. The initial five-year performance period commenced on January 1, 2012 and ended on December 31, 2016. For this performance period, we will payout approximately \$2.4 million to 12 Managing Partners who earned a bonus under this program. Their combined annual growth rate in Revenue and Field Level Operating Earnings was 4.9% and 10%, respectively.
- *The Right Local Leadership* – Successful execution of our operating model is highly dependent on strong local leadership as defined by our 4E Leadership Model, intelligent risk taking and entrepreneurial empowerment. A Managing Partner's performance is judged according to achievement of the standards for that business.

#### ***4E Leadership Model***

Our 4E Leadership Model requires strong local leadership in each business to grow an entrepreneurial, decentralized, high-value, personal service and sales business at sustainable profit margins. Our 4E Leadership Model is based upon principles established by Jack Welch during his tenure at General Electric, and is based upon 4E qualities essential to succeed in a high-performance culture: *Energy* to get the job done; the ability to *Energize* others; the *Edge* necessary to make difficult decisions; and the ability to *Execute* and produce results. To achieve a high level within our Standards in a business year after year, we require “A Players” in charge that have the 4E Leadership skills to entrepreneurially grow the business by hiring, training and developing highly motivated and productive teams locally that produce results.

#### ***Strategic Acquisition Model***

Our Standards Operating Model led to the development of our Strategic Acquisition Model, which guides our acquisition strategy. Both models, when executed effectively, will drive long-term, sustainable increases in market share, revenue, earnings and cash flow. We believe a primary driver of higher revenue and profits in the future will be the execution of our Strategic Acquisition Model using strategic ranking criteria to assess acquisition and divestiture candidates. As we execute this strategy over time, we will acquire larger, higher margin strategic businesses and divest smaller businesses in non-strategic markets.

We have learned that the long-term growth or decline of a local branded funeral and cemetery business is reflected by several criteria that correlate strongly with five to ten year performance in volumes (market share), revenues and sustainable field-level earnings before interest, taxes, depreciation and amortization (“EBITDA”) margins (a non-GAAP measure). We use the following criteria, to name a few, to rank the strategic position of each potential acquisition:

- volume and price trends;
- size of business;
- size of market;
- competitive standing;
- demographics;
- strength of brand; and
- barriers to entry.

The valuation of the acquisition candidate is then determined through the application of an appropriate after-tax cash return on investment that exceeds our cost of capital.

Our belief in our **Mission Statement** and **Guiding Principles** that define us and proper execution of the three models that define our strategy have given us the competitive advantage in any market in which we compete. We believe that we can execute our three models without proportionate incremental investment in our consolidation platform infrastructure or additional fixed regional and corporate overhead. This competitive advantage is evidenced by the sustained earning power of our portfolio as defined by our EBITDA margin. Our deep understanding of each market landscape and our historical, successful competition in individual local markets more than reasonably ensures that we are promoting the interests of the consumer and supporting unfettered markets which, in turn, results in better pricing and more choices for the consumer.

Other elements of our overall business strategy include the following:

*Enhancement of Funeral and Cremation Services.* Personalization and pre-planning continue to be two of the most important trends in the funeral and cremation services and merchandise industry, but the move toward more cremations may be the most significant. While this trend is expected to continue through at least 2020, other factors are expected to lead to rising industry revenues, including an increase in spending on additional or unique funeral and cremation services.

The percentage of funeral services performed by our funeral homes for which cremation was chosen was 47.3% for the year ended December 31, 2014, 48.9% for the year ended December 31, 2015 and 50.7% for the year ended December 31, 2016. For the year ended December 31, 2016, 66.1% of our total cremation services were direct cremations (where no memorial service or visitation is involved, although merchandise may be sold) and 33.9% included services, as compared to 65.8% and 34.2%, respectively, for the year ended December 31, 2015. Shifting preferences will likely continue to lead to a considerable rise in cremations; as such, we are focused on increasing the percentage of our cremation customers that choose additional services and products. All of our funeral homes offer cremation products and services. While the average revenue for a cremation service is generally lower than that of an average traditional, full-service funeral, we have found that these revenues can be substantially enhanced by our emphasis on offering additional services and merchandise, including counseling referrals, video tributes, flowers, burial garments and memorial items such as urns, keepsake jewelry and other items that hold a portion of the cremated remains.



*Preneed Funeral Sales Program.* We operate under a local, decentralized preneed sales strategy whereby each business location customizes its preneed program to its local needs. Approximately 19% of our funeral services performed are funded through preneed contracts, which are usually secured by placing the funds collected in trust for the benefit of the customer or by the purchase of a life insurance policy, the proceeds of which will pay for such services at the time of need. Insurance-funded contracts allow us to earn commission income to improve our near-term cash flow and offset a significant amount of the up-front costs associated with preneed sales. Trust funded contracts typically provide cash that is invested in various securities with the expectation that returns will exceed the growth factor in the insurance contracts. The cash flow and earnings from insurance contracts are more stable, but are generally lower than traditional trust fund investments. In markets that depend on preneed sales for market share, we supplement the arrangements written by funeral directors with sales sourced by sales counselors and third party sellers.

*Preneed Cemetery Sales Program.* Our preneed cemetery strategy is to build family heritage in our cemeteries by selling property and internment rights prior to death through full time, highly motivated and entrepreneurial local sales teams. Approximately 45% of our cemetery revenues are derived from preneed property sales. Cemetery merchandise and services are often purchased in addition to cemetery property at the time of sale. The performance of these preneed cemetery contracts is secured by placing the funds collected in trust for the benefit of the customer, the proceeds of which will pay for such services at the time of need. General consumer confidence and discretionary income have a significant impact on our preneed sales success rate. In 2016, our preneed cemetery sales increased 7.3% compared to 2015.

## OUR STRENGTHS

*Market Leader.* We compete with other public funeral and cemetery companies and smaller, independent operators and believe we are a market leader (first or second) in most of our markets. We focus on markets that perform better than the industry average and are generally insulated from material economic and demographic changes.

*High Performance, Decentralized, Partnership Culture.* Our funeral homes and cemeteries are managed by Managing Partners with extensive funeral and cemetery industry experience, often within their local markets. Our Managing Partners have responsibility for day-to-day operations, but are required to follow operating and financial standards based on our Standards Operating Model that are custom designed for each of our four business groupings which is based on the size (number of funerals) and average revenue per funeral. This strategy allows each local business to maintain its unique identity within its local market and to capitalize on its reputation and heritage while our senior leadership provides support services from our corporate headquarters in Houston, Texas. We believe our culture is very attractive to owners of premier independent businesses that fit our profile of suitable acquisition candidates.

*Flexible Capital Structure.* We have no near-term debt maturity issues. We believe that our capital structure provides us with financial flexibility by allowing us to invest our cash flow in growth opportunities, such as business acquisitions and cemetery inventory projects. For additional information regarding our capital structure, please see Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, Liquidity and Capital Resources.

*Stable Cash Flow.* We have demonstrated the ability to generate strong and stable cash flow. Cash flow from operations for 2016 totaled \$49.5 million, which was used primarily for the acquisition of six funeral home businesses, capital expenditures and our working capital needs. We intend to use our cash flow to acquire funeral home and cemetery businesses and to fund internal growth projects, such as cemetery inventory development. Our growth strategy is the primary way we expect to increase stockholder value. While we reassess our capital allocation strategy annually, we currently believe that our financial goals will best be achieved by continuing to improve the operating and financial performance of our existing portfolio of businesses while selectively investing our net cash flow in growth opportunities that generate a return on invested capital in excess of our weighted average cost of capital.

*Strong Field-Level Gross Profit Margins.* We believe that we have strong field-level gross profit margins and that this performance is a testament to the success of our business strategies. Our strong margins and the ability to control costs are important advantages in a business such as ours that is characterized by a high fixed-cost structure. We will continue to seek ways to improve our financial performance, and we believe that our Standards Operating Model will continue to yield long-term improvement in our financial results.

*Effective Execution of Funeral Preneed Sales.* We believe our local, decentralized strategy allows us to adapt our preneed sales selectively to best address the competitive situation in our particular markets. In highly competitive markets, we execute a more aggressive preneed sales program. In less competitive markets where we have a strong market position, we deploy a more passive preneed sales program. In certain of our markets, we do not deploy a formal preneed program. This approach allows us to target the investment in preneed sales to markets where we have the opportunity to reinforce our market share. Since



approximately 78% of our funeral revenues are generated from at-need sales, we retain significant pricing leverage in our funeral business without having to rely on preneed sales.

*Integrated Information Systems.* We have implemented information systems to support local business decisions and to monitor performance of our businesses compared to financial and performance standards. All of our funeral homes and cemeteries are connected to our corporate headquarters, which allows us to monitor and assess critical operating and financial data and analyze the performance of individual locations on a timely basis. Furthermore, our information system infrastructure provides senior management with a critical tool for monitoring and adhering to our established internal controls, which is critical given our decentralized model and the sensitive nature of our business operations.

*Proven Leadership Team.* Our leadership team is comprised of eight members, which we refer to as our Operations and Strategic Growth Leadership Team (“OSGLT”), headed by our founder, Chairman and Chief Executive Officer, Melvin C. Payne and seven leaders of our support functions and is characterized by a dynamic culture that focuses on addressing changing market conditions and emerging trends in the funeral services industry. We believe our culture of emphasizing the 4Es (Energy, Energize Others, Edge and Execution) leadership characteristics is critical and will provide an important advantage as the funeral and cemetery industry evolves. We are committed to continue operating an efficient organization and strengthening our corporate and local business leadership. Our businesses are led by a Regional Partner who is a member of the OSGLT. This promotes more cooperation and synergy between our funeral and cemetery operations and supports the goal of market-share and volume growth in our most significant markets.

## OPERATIONS

We conduct our funeral and cemetery operations only in the United States. Our operations are reported in two segments: funeral operations and cemetery operations. Information for each of our segments is presented below and in our financial statements set forth herein.

### *Funeral Home Operations*

At December 31, 2016, we operated 170 funeral homes in 28 states. Funeral home revenues currently account for approximately 76% of our total revenues. The funeral home operations are managed by a team of experienced funeral and cemetery industry professionals and regional leadership with substantial management experience in our industry. See Part II, Item 8, Financial Statements and Supplementary Data, Note 20 for segment data related to our funeral home operations.

Our funeral homes offer a complete range of services to meet a family’s deathcare needs, including consultation, the removal and preparation of remains, the sale of caskets and related funeral merchandise, the use of funeral home facilities for visitation and services and transportation services. Most of our funeral homes have a non-denominational chapel on the premises, which permits family visitation and services to take place at one location and thereby reduces transportation costs and inconvenience to the family.

Funeral homes are principally service businesses that provide burial and cremation services and sell related merchandise, such as caskets and urns. The sources and availability of caskets and urns are from a small number of national providers that have distribution centers near our businesses. We typically order and receive the merchandise within 24 hours. Given the high fixed-cost structure associated with funeral home operations, we believe the following are key factors affecting our profitability:

- our ability to establish and maintain market share positions supported by strong local heritage and relationships;
- our ability to effectively respond to the increasing trends towards cremation packaging complimentary services and merchandise;
- our ability to control salary, merchandise and other controllable costs;
- our ability to exercise pricing leverage related to our at-need business to increase average revenues per contract; and
- demographic trends in terms of population growth and average age, which impact death rates and number of deaths; and
- our response to fluctuations in capital markets and interest rates, which affect investment earnings on trust funds and our securities portfolio within the trust funds, which would offset lower pricing power as preneed contracts mature.

## ***Cemetery Operations***

At December 31, 2016, we operated 32 cemeteries in 11 states. Cemetery revenues currently account for approximately 24% of our total revenues. The cemetery operations are managed by a team of experienced funeral and cemetery industry and sales professionals and regional leadership with substantial management experience in our industry. See Part II, Item 8, Financial Statements and Supplementary Data, Note 20 for segment data related to our cemetery operations.

Our cemetery products and services include interment services, the rights to interment in cemetery sites (primarily grave sites, mausoleum crypts and niches) and related cemetery merchandise, such as memorials and vaults. Cemetery operations generate revenues through sales of interment rights and memorials, installation fees, fees for interment and cremation memorialization products, finance charges from installment sales contracts and investment income from preneed cemetery merchandise trusts and perpetual care trusts. Cemetery revenues generated from at-need services and merchandise sales generally are subject to many of the same key profitability factors as our funeral home business. Our cemetery operating results are affected by the following key factors:

- size and success of our sales organization;
- local perceptions and heritage of our cemeteries;
- our ability to adapt to changes in the economy and consumer confidence; and
- our response to fluctuations in capital markets and interest rates, which affect investment earnings on trust funds, finance charges on installment contracts and our securities portfolio within the trust funds.

## ***Preneed Programs***

We market funeral and cemetery services and products on a preneed basis at the local level. Preneed funeral or cemetery contracts enable families to establish, in advance, the type of service to be performed, the products to be used and the cost of such products and services. Preneed contracts permit families to eliminate issues of making deathcare plans at the time of need and allow input from other family members before the death occurs. We guarantee the price and performance of the preneed contracts to the customer.

Preneed funeral contracts are usually paid on an installment basis. The performance of preneed funeral contracts is usually secured by placing the funds collected in trust for the benefit of the customer or by the customer's purchase of a life insurance policy, the proceeds of which will pay for such services at the time of need. These methods are intended to fund preneed funeral contracts, cover the original contract price and generally include an element of growth (earnings) designed to offset future inflationary cost increases. Revenue from preneed funeral contracts, along with accumulated earnings, is not recognized until the time the funeral service is performed. The accumulated earnings from the trust investments and insurance policies are intended to offset the inflation in funeral prices. Additionally, we generally earn a commission from the insurance company from the sale of insurance-funded policies reflected in our Consolidated Financial Statements as Preneed funeral insurance commission within *Revenues: Funeral*. The commission income is recognized as revenue when the period of refund expires (generally one year), which helps us defray the costs we incur to originate the preneed contract (primarily commissions we pay to our sales counselors).

In addition to preneed funeral contracts, we also offer “pre-planned” funeral arrangements whereby a customer determines in advance substantially all of the details of a funeral service without any financial commitment or other obligation on the part of the client until the actual time of need. Pre-planned funeral arrangements permit a family to avoid issues of making deathcare plans at the time of need and enable a funeral home to establish relationships with a client that may eventually lead to an at-need sale.

Preneed sales of cemetery interment rights are usually financed through interest-bearing installment sales contracts, generally with terms of up to five years with such earnings reflected in our Consolidated Financial Statements as Preneed cemetery finance charges within *Revenues: Cemetery*. In substantially all cases, we receive an initial down payment at the time the contract is signed. Preneed sales of cemetery interment rights are recorded as revenue when 10% of the contract amount related to the interment right has been collected. Cemetery merchandise and services may similarly be sold on an installment basis, but revenue is recorded when delivery has occurred. Allowances for bad debts and customer cancellations are recorded at the date that the contract is executed and periodically evaluated thereafter based upon historical experience.

We sold 7,797 and 7,639 preneed funeral contracts, net of cancellations, during the years ended December 31, 2015 and 2016, respectively. At December 31, 2016, we had a backlog of 91,402 preneed funeral contracts and 63,254 preneed cemetery contracts to be delivered in the future. Approximately 19% of our funeral contract volumes during the years ended December 31, 2015 and 2016 originated through preneed contracts. Cemetery revenues that originated from preneed contracts represented approximately 50% of our net cemetery revenues for 2015 and 2016.

At December 31, 2016, we employed a staff of 210 advance-planning and family service representatives for the sale of preneed products and services. Our advance-planning and family service representatives primarily assist families in making at-need and pre-need funeral, memorialization and cemetery arrangements through the selection and purchase of cemetery property, merchandise and services and ensuring that the expectations of our client families and their guests are exceeded.

### **Trust Funds and Insurance Contracts**

We have established a variety of trusts in connection with funeral home and cemetery operations as required under applicable state laws. Such trusts include (i) preneed funeral trusts; (ii) preneed cemetery merchandise and service trusts; and (iii) cemetery perpetual care trusts. These trusts are typically administered by independent financial institutions selected by us. Investment management and advisory services are provided either by our wholly-owned registered investment advisory firm, CSV RIA, or by independent financial advisors. At December 31, 2016, CSV RIA provided these services to two institutions, which have custody of 79% of our trust assets, for a fee based on the market value of trust assets. Under state trust laws, we are allowed to charge the trust a fee for advising on the investment of the trust assets and these fees are recognized as income as the advisory services are provided. The investment advisors establish an investment policy that gives guidance on asset allocation, investment requirements, investment manager selection and performance monitoring. The investment objectives are tailored to generate long-term investment returns without assuming undue risk, while ensuring the management of assets is in compliance with applicable laws.

Preneed funeral sales generally require deposits to a trust or purchase of a third-party insurance product. Trust fund income earned, along with the receipt and recognition of any insurance benefits, are deferred until the service is performed or the merchandise is delivered. Trust fund holdings and deferred revenue are reflected on our Consolidated Balance Sheets, while the insurance contracts are not on our Consolidated Balance Sheets. In most states, we are not permitted to withdraw principal or investment income from such trusts until the funeral service is performed. Some states, however, allow for the retention of a percentage (generally 10%) of the receipts to offset any administrative and selling expenses. The aggregate balance of our preneed funeral contracts held in trust, insurance contracts and receivables from preneed trusts was approximately \$460.9 million as of December 31, 2016.

We are generally required under applicable state laws to deposit a specified amount (which varies from state to state, generally 50% to 100% of the selling price) into a merchandise and service trust fund for preneed cemetery merchandise and services sales. The related trust fund income earned is recognized when the related merchandise and services are delivered. We are generally permitted to withdraw the trust principal and accrued income when the merchandise is actually delivered, when the service is provided or when the contract is canceled. However, certain states allow the withdrawal of income prior to delivery when the regulations identify excess earnings in the trusts. We did not withdraw any trust income in 2015 and 2016. Cemetery merchandise and service trust fund balances totaled approximately \$69.7 million as of December 31, 2016.

In most states, regulations require a portion (generally 10%) of the sale amount of cemetery property and memorials to be placed in a perpetual care trust. The income from these perpetual care trusts provides funds necessary to maintain cemetery property and memorials in perpetuity. This trust fund income is recognized, as earned and is reflected in our Consolidated Financial Statements as *Revenues: Cemetery*. While we are entitled to withdraw the income from perpetual care trusts to provide for maintenance of cemetery property and memorials, we are restricted from withdrawing any of the principal balances of the trust fund. Perpetual care trust balances totaled approximately \$46.9 million at December 31, 2016.

For additional information with respect to our trusts, see Part II, Item 8, Financial Statements and Supplementary Data, Notes 6, 8 and 10.

### **SEASONALITY**

Our business can be affected by seasonal fluctuations in the death rate. Generally, the number of deaths is higher during the winter months because the incidences of death from influenza and pneumonia are higher during this period than other periods of the year.

### **COMPETITION**

The operating environment in the funeral and cemetery industry has been highly competitive. Publicly traded companies operating in the United States include SCI, StoneMor and Carriage. In addition, a number of smaller private consolidators have been active in acquiring and operating funeral homes and cemeteries.

Our funeral home and cemetery operations face competition in the markets that they serve. Our primary competition in most of our markets is from local independent operators. We have observed new start-up competition in certain areas of the country, which may impact our profitability in certain markets, because of the high fixed cost nature of our funeral home operations. Market share for funeral homes and cemeteries is largely a function of reputation and heritage, although competitive pricing, professional service and attractive, well-maintained and conveniently located facilities are also important. Because of the importance of

reputation and heritage, market share increases are usually gained over a long period of time. The sale of preneed funeral services and cemetery property has increasingly been used by many companies as a marketing tool to build market share.

There has been increasing competition from providers specializing in specific services, such as cremations, who offer minimal service and low-end pricing. We also face competition from companies that market products and related merchandise over the internet and non-traditional casket stores in certain markets. These competitors have been successful in capturing a portion of the low-end market and product sales.

## REGULATION

*General.* Our operations are subject to regulations, supervision and licensing under numerous federal, state and local laws, ordinances and regulations, including extensive regulations concerning trust funds, preneed sales of funeral and cemetery products and services and various other aspects of our business. We believe that we comply in all material respects with the provisions of these laws, ordinances and regulations.

*Federal Trade Commission.* Our funeral home operations are comprehensively regulated by the Federal Trade Commission (“FTC”) under Section 5 of the Federal Trade Commission Act and a trade regulation rule for the funeral industry promulgated thereunder referred to as the “Funeral Rule.” The Funeral Rule defines certain acts or practices as unfair or deceptive and contains certain requirements to prevent these acts or practices. The preventive measures require a funeral provider to give consumers accurate, itemized pricing information and various other disclosures about funeral goods and services and prohibit a funeral provider from: (i) misrepresenting legal, crematory and cemetery requirements; (ii) embalming for a fee without permission; (iii) requiring the purchase of a casket for direct cremation; (iv) requiring consumers to buy certain funeral goods or services as condition for furnishing other funeral goods or services; (v) misrepresenting state and local requirements for an outer burial container; and (vi) representing that funeral goods and services have preservative and protective value. Additionally, the Funeral Rule requires the disclosure of mark-ups, commissions, additional charges and rebates related to cash advance items.

*Environmental.* Our operations are also subject to stringent federal, regional, state and local laws and regulations relating to environmental protection, including legal requirements governing air emissions, waste management and disposal and wastewater discharges. For instance, the federal Clean Air Act and analogous state laws, which restrict the emission of pollutants from many sources, including crematories, may require us to apply for and obtain air emissions permits, install costly emissions control equipment, and conduct monitoring and reporting tasks. Also, in the course of our operations, we store and use chemicals and other regulated substances as well as generate wastes that may subject us to strict liability under the federal Resource Conservation and Recovery Act and comparable state laws, which govern the treatment, storage, and disposal of nonhazardous and hazardous wastes, and the federal Comprehensive Environmental Response, Compensation and Liability Act, a remedial statute that imposes cleanup obligations on current and past owners or operators of facilities where hazardous substance releases occurred and anyone who transported or disposed or arranged for the transportation or disposal of hazardous substances released into the environment from such sites. In addition, the Federal Water Pollution Control Act, also known as the federal Clean Water Act, and analogous state laws regulate discharges of pollutants to state and federal waters. Underground and aboveground storage tanks that store chemicals and fuels for vehicle maintenance or general operations are located at certain of our facilities and any spills or releases from those facilities may cause us to incur remedial liabilities under the Clean Water Act or analogous state laws as well as potential liabilities for damages to properties or persons. Failure to comply with environmental laws and regulations could result in the assessment of sanctions, including administrative, civil, and criminal penalties, the imposition of investigatory, remedial and corrective action obligations, delays in permitting or performance of projects and the issuance of injunctions restricting or prohibiting some or all of our activities in affected areas. Moreover, accidental releases or spills may occur in the course of our operations, and we cannot assure you that we will not incur significant costs and liabilities as a result of such releases or spills, including any third party claims for damages to property, natural resources or persons. Also, it is possible that implementation of stricter environmental laws and regulations or more stringent enforcement of existing environmental requirements could result in additional, currently unidentifiable costs or liabilities to us, such as requirements to purchase pollution control equipment or implement operational changes or improvements. While we believe we are in substantial compliance with existing environmental laws and regulations, we cannot assure you that we will not incur substantial costs in the future.

*Worker Health and Safety.* We are subject to the requirements of the federal Occupational Safety and Health Act, as amended (“OSHA”), and comparable state statutes whose purpose is to protect the health and safety of workers. In addition, the OSHA hazard communication standard, the Emergency Planning and Community Right to Know Act and implementing regulations and similar state statutes and regulations require that we organize and/or disclose information about hazardous materials used or produced in our operations and that this information be provided to employees, state and local governmental authorities and citizens. We believe that we are in substantial compliance with all applicable laws and regulations relating to worker health and safety.

## EMPLOYEES

As of December 31, 2016, we and our subsidiaries employed 2,509 employees, of whom 1094 were full-time and 1,415 were part-time. All of our funeral directors and embalmers possess licenses required by applicable regulatory agencies. None of our employees are represented by unions.

## AVAILABLE INFORMATION

We file annual, quarterly and other reports, and any amendments to those reports, and information with the United States Securities and Exchange Commission (“SEC”). You may read and copy any materials we file with the SEC at the SEC’s Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. You may obtain additional information about the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains a website at [www.sec.gov](http://www.sec.gov) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, including us.

Our website address is [www.carriageservices.com](http://www.carriageservices.com). Available on this website under “Investors – SEC Filings,” free of charge, are Carriage’s annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, insider reports on Forms 3, 4 and 5 filed on behalf of directors and officers and amendments to those reports as soon as reasonably practicable after such materials are electronically filed with or furnished to the SEC.

Also posted on our website, and available in print upon request, are charters for our Audit Committee, Compensation Committee and Corporate Governance Committee. Copies of the Code of Business Conduct and Ethics and the Corporate Governance Guidelines are also posted on our website under “Investors – Corporate Governance.” Within the time period required by the SEC and the New York Stock Exchange, we will post on our website any modifications to the charters and any waivers applicable to senior officers as defined in the applicable charters, as required by the Sarbanes-Oxley Act of 2002.

## ITEM 1A. RISK FACTORS

### RISKS RELATED TO OUR BUSINESS

**The success of our businesses is typically dependent upon one or a few key employees for success because of the localized and personal nature of our business.**

Funeral home and cemetery businesses have built local heritage and tradition through successive generations, providing a foundation for ongoing business opportunities from established client family relationships and related referrals. We believe these relationships build trust in the community and are a key driver to market share. Our businesses, which tend to serve small local markets, usually have one or a few key employees that drive our relationships. Our ability to attract and retain Managing Partners, sales force and other personnel is an important factor in achieving future success. We can give no assurance that we can retain these employees or that these relationships will drive market share. Our inability to attract and maintain qualified and productive Managing Partners and sales force could have a material adverse effect on our financial condition, results of operations and cash flows.

**Our ability to execute our growth strategy is highly dependent upon our ability to successfully identify suitable acquisition candidates and negotiate transactions on favorable terms.**

Our growth strategy is the primary way we expect to increase stockholder value. There is no assurance that we will be able to continue to identify acquisition candidates that meet our criteria or that we will be able to reach terms with identified candidates for transactions that are acceptable to us, and even if we do, we may not be able to successfully complete the transaction or integrate the new business into our existing business. We intend to apply standards established under our Strategic Acquisition Model to evaluate acquisition candidates, and there is no assurance that we will continue to be successful in doing so or that we will find attractive candidates that satisfy these standards. Due in part to the presence of competitors who have been in certain markets longer than we have, such acquisitions or investments may be more difficult or expensive than we anticipate.

**Marketing and sales activities by existing and new competitors could cause us to lose market share and lead to lower revenues and margins.**

We face competition in all of our markets. Most of our competitors are independently owned, and some are relatively recent market entrants. Some of the recent entrants are individuals who were formerly employed by us or by our competitors and have relationships and name recognition within our markets. As a group, independent competitors tend to be aggressive in distinguishing themselves by their independent ownership, and they promote their independence through television, radio and print advertising, direct mailings and personal contact. Increasing pressures from new market entrants and continued advertising and marketing by competitors in local markets could cause us to lose market share and revenues. In addition, competitors may change the types or mix of products or services offered. These changes may attract customers, causing us to lose market share and revenue as well as



to incur costs in response to competition to vary the types or mix of products or services offered by us. Also, increased use of the internet by customers to research and/or purchase products and services could cause us to lose potential revenue.

**Improved performance in our funeral and cemetery segments is dependent upon successful execution of our Standards Operating Model.**

We have implemented our Standards Operating Model to improve and better measure performance in our funeral and cemetery operations. We developed standards according to criteria, each with a different weighting, designed around market share, people and operational and financial metrics. We also incentivize our location Managing Partners by giving them the opportunity to earn a fixed percentage of the field-level earnings before interest, taxes, depreciation and amortization based upon the number and weighting of the standards achieved. Our expectation is that, over time, the Standards Operating Model will result in improving field-level margins, market share, customer satisfaction and overall financial performance, but there is no assurance that these goals will be met. Failure to successfully implement our Standards Operating Model in our funeral and cemetery operations could have a material adverse effect on our financial condition, results of operations and cash flows.

**Our “Good to Great” incentive program could result in significant future payments to our Managing Partners.**

In January, 2012, in order to continue to align our Managing Partners' incentives with the long-term interests of our stockholders, we implemented our “**Good to Great**” incentive program, which rewards our Managing Partners for achieving an average net revenue compounded annual growth rate equal to at least 2% (the “Minimum Growth Rate”) over a five-year performance period (the “Performance Period”) with respect to our funeral homes that they operate. The initial Performance Period commenced on January 1, 2012 and ended on December 31, 2016. The Performance Periods for new Managing Partners commences each year after 2012. Each Managing Partner that achieves the Minimum Growth Rate during the applicable Performance Period and remains continuously employed as a Managing Partner of the same business throughout the Performance Period will receive a one-time bonus, payable in a combination of cash and shares of our common stock, determined at our discretion. We believe this incentive program will result in improved field-level margins, market share and overall financial performance. For the first five-year performance period which ended December 31, 2016, we will payout approximately \$2.4 million to 12 Managing Partners who earned a bonus under this program. Their combined annual growth rate in Revenue and Field Level Operating Earnings was 4.9% and 10%, respectively.

**Price competition could also reduce our market share or cause us to reduce prices to retain or recapture market share, either of which could reduce revenues and margins.**

We have historically experienced price competition primarily from independent funeral home and cemetery operators, and from monument dealers, casket retailers, low-cost funeral providers and other non-traditional providers of services or products. New market entrants tend to attempt to build market share by offering lower cost alternatives. In the past, this price competition has resulted in our losing market share in some markets. In other markets, we have had to reduce prices or offer discounts thereby reducing profit margins in order to retain or recapture market share. Increased price competition in the future could further reduce revenues, profits and our preneed backlog.

**Our ability to generate preneed sales depends on a number of factors, including sales incentives and local and general economic conditions.**

Significant declines in preneed sales would reduce our backlog and revenue and could reduce our future market share. On the other hand, a significant increase in preneed sales can have a negative impact on cash flow as a result of commissions and other costs incurred initially without corresponding revenues.

As we have localized our preneed sales strategies, we are continuing to refine the mix of service and product offerings in both our funeral and cemetery segments, including changes in our sales commission and incentive structure. These changes could cause us to experience declines in preneed sales in the short-run. In addition, economic conditions at the local or national level could cause declines in preneed sales either as a result of less discretionary income or lower consumer confidence. Declines in preneed cemetery property sales reduces current revenue, and declines in other preneed sales would reduce our backlog and future revenue and could reduce future market share.

**Increased preneed sales could have a negative impact on our cash flows.**

Preneed sales of funeral and cemetery products and services generally have an initial negative impact on our cash flows, as we are required to deposit a portion of the sales proceeds into trusts or escrow accounts and often incur other expenses at the time of sale. Furthermore, many preneed purchases are paid for in installments over a period of several years, further reducing our cash flows at the time of sale. Because preneed sales generally provide positive cash flows over the long term, we market the sale of such contracts at the local level. If our efforts to increase such sales are successful, however, our current cash flows could be materially and adversely affected.

**Our funeral and cemetery trust funds own investments in equity securities, fixed income securities, and mutual funds, which are affected by market conditions that are beyond our control.**

In connection with our backlog of preneed funeral and preneed cemetery merchandise and service contracts, funeral and cemetery trust funds own investments in equity securities, fixed income securities and mutual funds. Our returns on these investments are affected by financial market conditions that are beyond our control.

The following table summarizes our investment returns (realized and unrealized), excluding certain fees, on our trust funds for the years ended December 31, 2014, 2015 and 2016:

	2014	2015	2016
Preneed funeral trust funds	7.4%	(2.2)%	17.0%
Preneed cemetery trust funds	8.3%	(3.0)%	19.6%
Perpetual care trust funds	8.4%	(3.3)%	19.2%

Generally, earnings or gains and losses on our preneed funeral and cemetery trust investments are recognized, and we withdraw cash, when the underlying service is performed, merchandise is delivered, or upon contract cancellation. Our cemetery perpetual care trusts recognize earnings, and in certain states, capital gains and losses, and we withdraw cash when we incur qualifying cemetery maintenance costs. If the investments in our trust funds experience significant, recurring and sustained declines in subsequent years, there could be insufficient funds in the trusts to cover the costs of delivering services and merchandise or maintaining cemeteries in the future. We may be required to cover any such shortfall with cash flows from operations, which could have a material adverse effect on our financial condition, results of operations or cash flows. For more information related to our trust investments, see Part II, Item 8, Financial Statements and Supplementary Data, Notes 6 and 10.

If the fair market value of these trusts, plus any other amount due to us upon delivery of the associated contracts, were to decline below the estimated costs to deliver the underlying products and services, we would record a charge to earnings to record a liability for the expected losses on the delivery of the associated contracts. As of December 31, 2016, no such charge was required. For additional information, see Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, Critical Accounting Policies and Estimates.

**Earnings from and principal of trust funds could be reduced by changes in financial markets and the mix of securities owned.**

Earnings and investment gains and losses on trust funds are affected by financial market conditions and the specific fixed-income and equity securities that we choose to maintain in the funds. We may not choose the optimal mix for any particular market condition. Declines in earnings from perpetual care trust funds would cause a decline in current revenues, while declines in earnings from other trust funds could cause a decline in future cash flows and revenues.

**We may be required to replenish our funeral and cemetery trust funds in order to meet minimum funding requirements, which would have a negative effect on our earnings and cash flow.**

In certain states, we have withdrawn allowable distributable earnings including gains prior to the maturity or cancellation of the related contract. Additionally, some states have laws that either require replenishment of investment losses under certain circumstances or impose various restrictions on withdrawals of future earnings when trust fund values drop below certain prescribed amounts. In the event of realized losses or market declines, we may be required to deposit portions or all of these amounts into the respective trusts in some future period.

**Increasing death benefits related to preneed funeral contracts funded through life insurance contracts may not cover future increases in the cost of providing a price-guaranteed funeral service.**

We sell price-guaranteed preneed funeral contracts through various programs providing for future funeral services at prices prevailing when the agreements are signed. For preneed funeral contracts funded through life insurance contracts, we receive in cash a general agency commission from the third-party insurance company. Additionally, there is an increasing death benefit associated with the contract that may vary over the contract life. There is no guarantee that the increasing death benefit will cover future increases in the cost of providing a price-guaranteed funeral service, and any such excess cost could be materially adverse to our future cash flows, revenues, and operating margins.

**The financial condition of third-party insurance companies that fund our preneed funeral contracts may impact our future revenues.**

Where permitted by state law, our customers may arrange their preneed funeral contract by purchasing a life insurance policy from third-party insurance companies. The customer/policy holder assigns the policy benefits to our funeral home to pay for the preneed funeral contract at the time of need. If the financial condition of the third-party insurance companies were to deteriorate



materially because of market conditions or otherwise, there could be an adverse effect on our ability to collect all or part of the proceeds of the life insurance policy, including the annual increase in the death benefit, when we fulfill the preneed contract at the time of need. Failure to collect such proceeds could have a material adverse effect on our financial condition, results of operations, or cash flows.

**Increased or unanticipated costs, such as insurance or taxes, may have a negative impact on our earnings and cash flow.**

We may experience material increases in certain costs, such as insurance or taxes. Future cost increases are difficult to quantify and could materially and adversely affect our results of operations and cash flows.

**New or revised tax regulations could have a material effect on our financial results.**

The tax environment in which we operate is evolving rapidly with the enactment, or the proposal to enact, sweeping corporate tax legislative changes. Changes in tax laws or tax rates under the new administration may have a positive or negative impact on earnings and cash flow. Significant judgment is required in determining the impact of potential legislative changes on our provision for income taxes. While we expect that the currently proposed legislative changes would have a beneficial impact on earnings and cash flows, the final and enacted legislation could result in a different outcome.

**Covenant restrictions under our debt instruments may limit our flexibility in operating and growing our business.**

The terms of our Credit Agreement and the Convertible Notes may limit our ability and the ability of our subsidiaries to, among other things: incur additional debt; pay dividends or make distributions or redeem or repurchase stock; make investments; grant liens; make capital expenditures; enter into transactions with affiliates; enter into sale-leaseback transactions; sell assets; and acquire the assets of, or merge or consolidate with, other companies.

Our Credit Agreement also requires us to maintain certain financial ratios. Complying with these restrictive covenants and financial ratios, as well as those that may be contained in any future debt agreements, may limit our ability to finance our future operations or capital needs or to take advantage of other favorable business opportunities. Our ability to comply with these restrictive covenants and financial ratios will depend on our future performance, which may be affected by events beyond our control. Our failure to comply with any of these covenants or restrictions when they apply could result in a default under any future debt instrument, which could result in acceleration of the debt under that instrument and, in some cases, the acceleration of debt under other instruments that contain cross-default or cross-acceleration provisions. In the case of an event of default, or in the event of a cross-default or cross-acceleration, we may not have sufficient funds available to make the required payments under our debt instruments. If we are unable to repay amounts owed under the terms of our Credit Agreement, the lenders thereunder may be entitled to sell certain of our funeral assets to satisfy our obligations under the agreement.

**Economic, financial and stock market fluctuations could affect future potential earnings and cash flows and could result in future goodwill, intangible assets and long-lived asset impairments.**

In addition to an annual review, we assess the impairment of goodwill, intangible assets and other long-lived assets whenever events or changes in circumstances indicate that the carrying value may be greater than fair value. Factors that could trigger an interim impairment review include, but are not limited to, a significant decline in the market value of our stock or debt values, significant under-performance relative to historical or projected future operating results, and significant negative industry or economic trends. If these factors occur, we may have a triggering event, which could result in an impairment of our goodwill. Based on the results of our annual goodwill and intangible assets impairment test we performed as of August 31, 2016 and our annual review of long-lived assets as of December 31, 2016, we concluded that there was no impairment of our goodwill, intangible assets or other long-lived assets. However, if current economic conditions weaken causing deterioration in our operating revenues, operating margins and cash flows, we may have a triggering event that could result in a material impairment of our goodwill, intangible assets and/or long-lived assets.

**We rely significantly on information technology and any failure, inadequacy, interruption or security lapse of that technology, including any cybersecurity incidents, could harm our ability to operate our business effectively.**

In the ordinary course of our business, we receive certain personal information, in both physical and electronic formats, about our customers, their loved ones, our associates, and our vendors. We maintain substantial security measures and data backup systems to protect, store, and prevent unauthorized access to such information. Nevertheless, it is possible that computer hackers and others (through cyberattacks, which are rapidly evolving and becoming increasingly sophisticated, or by other means) might defeat our security measures in the future and obtain the personal information of customers, their loved ones, our associates, and our vendors that we hold. If we fail to protect our own information, we could experience significant costs and expenses as well as damage to our reputation.

Our ability to manage and maintain our internal reports effectively and integration of new business acquisitions depends significantly on our enterprise resource planning system and other information systems. Some of our information technology systems may experience interruptions, delays or cessations of service or produce errors in connection with ongoing systems

implementation work. The failure of our systems to operate effectively or to integrate with other systems, or a breach in security or other unauthorized access of these systems, may also result in reduced efficiency of our operations and could require significant capital investments to remediate any such failure, problem or breach and to comply with applicable regulations, all of which could adversely affect our business, financial condition and results of operations.

## **RISKS RELATED TO THE FUNERAL AND CEMETERY INDUSTRY**

**Declines in the number of deaths in our markets can cause a decrease in revenues. Changes in the number of deaths are not predictable from market to market or over the short term.**

Declines in the number of deaths could cause at-need sales of funeral and cemetery services, property and merchandise to decline, which could decrease revenues. Although the United States Bureau of the Census estimates that the number of deaths in the United States will increase in the future, longer life spans could reduce the rate of deaths. In addition, changes in the number of deaths can vary among local markets and from quarter to quarter, and variations in the number of deaths in our markets or from quarter to quarter are not predictable. These variations may cause our revenues to fluctuate and our results of operations to lack predictability.

**The increasing number of cremations in the United States could cause revenues to decline because we could lose market share to firms specializing in cremations. In addition, direct cremations produce minimal revenues for cemetery operations and lower funeral revenues.**

Our traditional cemetery and funeral service operations face competition from the increasing number of cremations in the United States. Industry studies indicate that the percentage of cremations has increased every year and this trend is expected to continue into the future. The trend toward cremation could cause cemeteries and traditional funeral homes to lose market share and revenues to firms specializing in cremations. In addition, direct cremations (with no funeral service, casket, urn, mausoleum niche, columbarium niche or burial) produce no revenues for cemetery operations and lower revenues than traditional funerals and, when delivered at a traditional funeral home, produce lower profits as well.

**If we are not able to respond effectively to changing consumer preferences, our market share, revenues and profitability could decrease.**

Future market share, revenues and profits will depend in part on our ability to anticipate, identify and respond to changing consumer preferences. In past years, we have implemented new product and service strategies based on results of customer surveys that we conduct on a continuous basis. However, we may not correctly anticipate or identify trends in consumer preferences, or we may identify them later than our competitors do. In addition, any strategies we may implement to address these trends may prove incorrect or ineffective.

**Because the funeral and cemetery businesses are high fixed-cost businesses, changes in revenue can have a disproportionately large effect on cash flow and profits.**

Companies in the funeral home and cemetery business must incur many of the costs of operating and maintaining facilities, land and equipment regardless of the level of sales in any given period. For example, we must pay salaries, utilities, property taxes and maintenance costs on funeral homes and maintain the grounds of cemeteries regardless of the number of funeral services or interments performed. Because we cannot decrease these costs significantly or rapidly when we experience declines in sales, declines in sales can cause margins, profits and cash flow to decline at a greater rate than the decline in revenues.

**Changes or increases in, or failure to comply with, regulations applicable to our business could increase costs or decrease cash flows.**

The funeral and cemetery industry is subject to extensive and evolving regulation and licensing requirements under federal, state and local laws. For example, the funeral home industry is regulated by the FTC, which requires funeral homes to take actions designed to protect consumers. State laws impose licensing requirements and regulate preneed sales. As such, we are subject to state trust fund and preneed sales practice audits, which could result in audit adjustments as a result of non-compliance. In addition, we assume the liability for any audit adjustments for our acquired businesses for periods under audit that were prior to our ownership of the business. These audit adjustments could have a material adverse impact on our financial condition, results of operations and cash flows.

Embalming and cremation facilities are subject to stringent environmental and health regulations. Compliance with these regulations is burdensome, and we are always at risk of not complying with the regulations or facing costly and burdensome investigations from regulatory authorities.

In addition, from time to time, governments and agencies propose to amend or add regulations, which could increase costs or decrease cash flows. Several states and regulatory agencies have considered or are considering regulations that could require

more liberal refund and cancellation policies for preneed sales of products and services, limit or eliminate our ability to use surety bonding, increase trust requirements and/or prohibit the common ownership of funeral homes and cemeteries in the same market. If adopted by the regulatory authorities of the jurisdictions in which we operate, these and other possible proposals could have a material adverse effect on us, our financial condition, our results of operations and our future prospects. For additional information regarding the regulation of the funeral and cemetery industry, see Part I, Item 1, Business, Regulation.

**We are subject to environmental and worker health and safety laws and regulations that may expose us to significant costs and liabilities.**

Our cemetery and funeral home operations are subject to stringent federal, regional, state and local laws and regulations governing worker health and safety aspects of the operations, the release or disposal of materials into the environment or otherwise relating to environmental protection. These laws and regulations may restrict or impact our business in many ways, including requiring the acquisition of a permit before conducting regulated activities, restricting the types, quantities and concentration of substances that can be released into the environment, applying specific health and safety criteria addressing worker protection, and imposing substantial liabilities for any pollution resulting from our operations. We may be required to make significant capital and operating expenditures to comply with these laws and regulations and any failure to comply may result in the assessment of sanctions, including administrative, civil and criminal penalties, imposition of investigatory, remedial or corrective action obligations, delays in permitting or performance of projects and the issuance of injunctions restricting or prohibiting our activities. Failure to appropriately transport and dispose of generated wastes, used chemicals or other regulated substances, or any spills or other unauthorized releases of regulated substances in the course of our operations could expose us to material losses, expenditures and liabilities under applicable environmental laws and regulations, and result in neighboring landowners and other third parties filing claims for personal injury, property damage and natural resource damage allegedly caused by such non-compliant activities or spills or releases. Certain of these laws may impose strict, joint and several liabilities upon us for the remediation of contaminated property resulting from our or a predecessor owner's or operator's operations. We may not be able to recover some or any of these costs from insurance or contractual indemnifications. Moreover, changes in environmental laws, regulations and enforcement policies occur frequently, and any changes that result in more stringent or costly emissions control or waste handling, storage, transport, disposal or cleanup requirements could require us to make significant expenditures to attain and maintain compliance and may otherwise have a material adverse effect on our results of operations, competitive position or financial condition.

**Burial practice claims could have a material adverse impact on our financial results.**

From time to time, we are party to various claims and legal proceedings, including burial practices. When cemetery disputes occur, we may be subjected to litigation and liability for improper burial practices. In addition, since we acquired most of our cemeteries through various acquisitions, we may be subject to litigation and liability based upon actions or events that occurred before we acquired or managed the cemeteries. Claims or litigation based upon our cemetery burial practices could have a material adverse impact on our financial condition, results of operations and cash flows.

**ITEM 1B. UNRESOLVED STAFF COMMENTS.**

None.

**ITEM 2. PROPERTIES.**

At December 31, 2016, we operated 170 funeral homes in 28 states and 32 cemeteries in 11 states. We own the real estate and buildings for 148 of our funeral homes and lease 22 facilities. We own 28 cemeteries and operate four cemeteries under long-term contracts with municipalities and non-profit organizations, which we refer to as managed properties. We operate 13 funeral homes in combination with cemeteries as these locations are physically located on the same property or in very close proximity and are under the same leadership.

The 32 cemeteries, operated by us have an inventory of unsold developed lots totaling approximately 142,725 and 144,068 at December 31, 2015 and 2016, respectively. In addition, we own approximately 456 acres that are available for future development or sale. We anticipate having a sufficient inventory of lots to maintain our property sales for the foreseeable future.

The following table sets forth certain information as of December 31, 2016, regarding our properties used by the funeral home segment and by the cemetery segment identified by state:

State	Number of Funeral Homes		Number of Cemeteries	
	Owned	Leased <sup>(1)</sup>	Owned	Managed
California	23	5	4	—
Connecticut	8	2	—	—
Florida	11	5	5	3
Georgia	4	—	—	—
Idaho	5	1	3	—
Illinois	2	1	1	—
Kansas	2	—	—	—
Kentucky	9	1	1	—
Louisiana	3	1	1	—
Maryland	1	—	—	—
Massachusetts	12	—	—	—
Michigan	2	—	—	—
Montana	2	1	1	—
Nevada	2	—	2	1
New Jersey	4	1	—	—
New Mexico	1	—	—	—
New York	2	—	—	—
North Carolina	6	1	1	—
Ohio	4	—	—	—
Oklahoma	6	—	2	—
Pennsylvania	1	—	—	—
Rhode Island	4	—	—	—
Tennessee	4	—	—	—
Texas	21	1	7	—
Virginia	5	1	—	—
Washington	2	—	—	—
West Virginia	1	1	—	—
Wisconsin	1	—	—	—
Total	148	22	28	4

(1) The leases, with respect to these funeral homes, generally have remaining terms ranging from one to ten years, and generally, we have the right to renew past the initial terms and have a right of first refusal on any proposed sale of the property where these funeral homes are located.

Our corporate headquarters occupy approximately 48,000 square feet of leased office space in Houston, Texas. At December 31, 2016, we owned and operated 881 vehicles and leased 2 vehicles.

### ITEM 3. LEGAL PROCEEDINGS.

We and our subsidiaries are parties to a number of legal proceedings that arise from time to time in the ordinary course of our business. While the outcome of these proceedings cannot be predicted with certainty, we do not expect these matters to have a material adverse effect on our financial statements. Information regarding litigation is set forth in Part II, Item 8, Financial Statements and Supplementary Data, Note 15.

We self-insure against certain risks and carry insurance with coverage and coverage limits for risks in excess of the coverage amounts consistent with our assessment of risks in our business and of an acceptable level of financial exposure. Although there can be no assurance that self-insurance reserves and insurance will be sufficient to mitigate all damages, claims or contingencies,

we believe that the reserves and our insurance provide reasonable coverage for known asserted and unasserted claims. In the event we sustain a loss from a claim and the insurance carrier disputes coverage or coverage limits, we may record a charge in a different period than the recovery, if any, from the insurance carrier.

**ITEM 4. MINE SAFETY DISCLOSURES.**

Not applicable.

**PART II**

**ITEM 5. MARKET FOR REGISTRANT’S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.**

**MARKET INFORMATION**

Our common stock is traded on the New York Stock Exchange under the symbol “CSV.” The following table presents the quarterly high and low sale prices as reported by the New York Stock Exchange:

<u>2016</u>	<u>High</u>	<u>Low</u>
First Quarter	\$ 23.85	\$ 19.03
Second Quarter	\$ 24.94	\$ 21.25
Third Quarter	\$ 24.97	\$ 22.53
Fourth Quarter	\$ 29.11	\$ 23.06

<u>2015</u>	<u>High</u>	<u>Low</u>
First Quarter	\$ 25.20	\$ 19.41
Second Quarter	\$ 25.65	\$ 22.98
Third Quarter	\$ 24.57	\$ 20.03
Fourth Quarter	\$ 25.96	\$ 21.01

As of February 16, 2017, there were 16,660,755 shares of our common stock outstanding and the closing price as reported by the New York Stock Exchange was \$26.82 per share. The shares of common stock outstanding are held by approximately 475 stockholders of record. Each share is entitled to one vote on matters requiring the vote of stockholders. We believe there are approximately 5,300 beneficial owners of our common stock.

**DIVIDENDS**

The following table sets forth certain information with respect to the payment of cash dividends on our common stock:

<u>2016</u>	<u>Per Share</u>	<u>Dollar Value</u>
First Quarter	\$ 0.025	\$ 415,000
Second Quarter	\$ 0.025	\$ 415,000
Third Quarter	\$ 0.050	\$ 831,000
Fourth Quarter	\$ 0.050	\$ 830,000

<u>2015</u>	<u>Per Share</u>	<u>Dollar Value</u>
First Quarter	\$ 0.025	\$ 463,000
Second Quarter	\$ 0.025	\$ 462,000
Third Quarter	\$ 0.025	\$ 460,000
Fourth Quarter	\$ 0.025	\$ 434,000

While we intend to pay regular quarterly cash dividends for the foreseeable future, covenant restrictions under our Credit Agreement may limit our ability to pay dividends in the future.

## EQUITY PLANS

For information regarding securities authorized for issuance under our equity compensation plans, see Part III, Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

## PURCHASES OF EQUITY SECURITIES BY THE ISSUER

On February 25, 2016, our Board approved a share repurchase program authorizing us to purchase up to an aggregate of \$25.0 million of our common stock in accordance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended. The shares may be purchased from time to time in the open market or in privately negotiated transactions. Purchases will be at times and in amounts as management deems appropriate based on factors such as market conditions, legal requirements and other business considerations. During the year ended December 31, 2016, we did not repurchase any shares of common stock pursuant to this share repurchase program.

The following table sets forth certain information with respect to repurchases of our common stock during the quarter ended December 31, 2016:

Period	Total Number of Shares Purchased <sup>(1)</sup>	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Dollar Value of Shares That May Yet Be Purchased Under the Program
October 1, 2016 - October 31, 2016	—	\$ —	—	\$ —
November 1, 2016 - November 30, 2016	—	\$ —	—	\$ —
December 1, 2016 - December 31, 2016	3,317	\$ 27.79	—	\$ —
Total for quarter ended December 31, 2016	3,317		—	

(1) Represents shares surrendered by an employee to pay the option exercise price with company stock that the option holder owns.

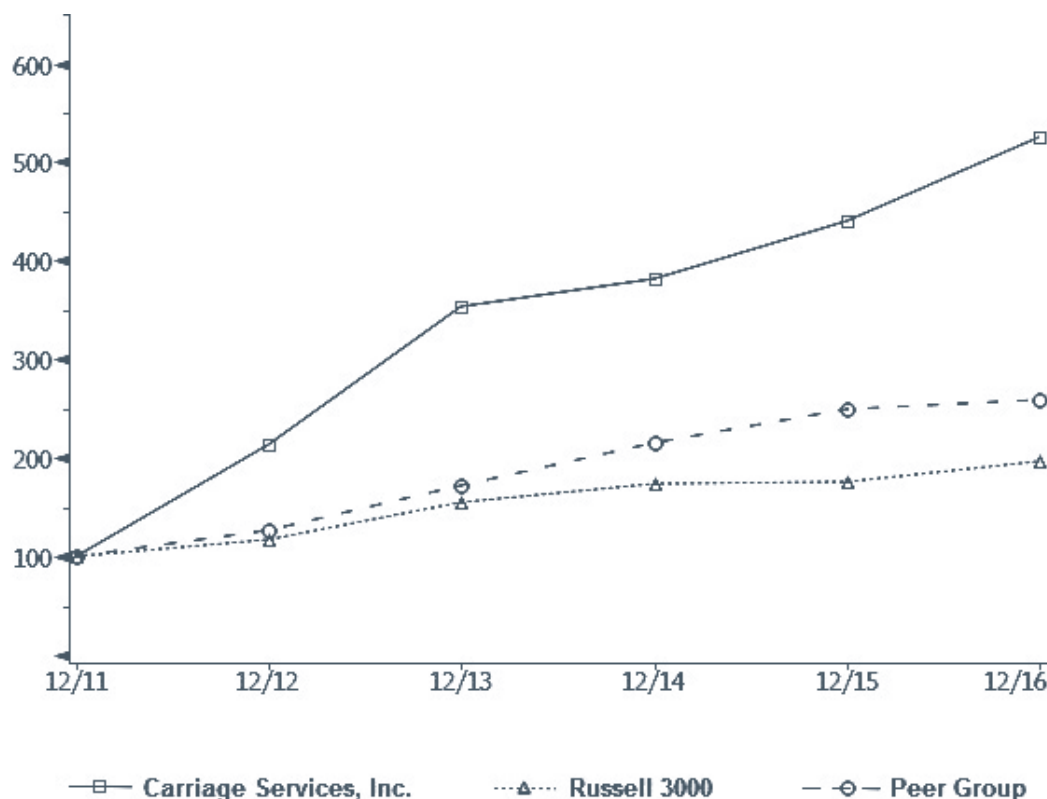
On May 19, 2015, our Board approved a share repurchase program authorizing us to purchase up to an aggregate of \$25.0 million of our common stock in accordance with the Exchange Act. On September 28, 2015, our Board authorized additional repurchases of \$20.0 million of our common stock bringing the total authorized repurchase amount to \$45.0 million. During the year ended December 31, 2015, we purchased 1,927,665 shares of our common stock for a total cost of \$45.0 million, representing the entire authorized repurchase amount, at an average cost of \$23.34 per share.

## PERFORMANCE

The following graph compares the cumulative 5-year total return provided to shareholders on our common stock relative to the cumulative total returns of the Russell 3000 Index, and a customized peer group of two companies that includes SCI and StoneMor. The returns of each member of the peer group are weighted according to each member's stock market capitalization as of the beginning of each period measured. The graph assumes that the value of the investment in our common stock, the Russell 3000 Index and the peer group was \$100 on the last trading day of December 2011, and that all dividends were reinvested. Performance data for Carriage, the Russell 3000 Index and the peer group is provided as of the last trading day of each of our last five fiscal years.

The following graph and related information shall not be deemed "soliciting material" or "filed" with the SEC, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, each as amended, except to the extent that we specifically incorporate it by reference.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***  
Among Carriage Services, Inc., the Russell 3000 Index and a Peer Group



\* \$100 invested on December 31, 2011 in stock or index, including reinvestment of dividends.

Fiscal year ending December 31. Peer Group includes SCI and StoneMor.

	12/11	12/12	12/13	12/14	12/15	12/16
Carriage Services, Inc.	\$ 100.00	\$ 218.16	\$ 361.05	\$ 389.43	\$ 449.91	\$ 538.09
Russell 3000	100.00	114.69	153.19	172.43	173.24	195.28
Peer Group	100.00	127.13	171.26	215.17	248.73	258.90

The stock price performance included in this graph is not necessarily indicative of future stock price performance.



**ITEM 6.           SELECTED FINANCIAL DATA.**

The table on the following page sets forth selected consolidated financial information for us that has been derived from the audited Consolidated Financial Statements of the Company as of and for each of the years ended December 31, 2012, 2013, 2014, 2015 and 2016. These historical results are not indicative of our future performance.

You should read this historical financial data together with “Management's Discussion and Analysis of Financial Condition and Results of Operations” included in this Form 10-K and our Consolidated Financial Statements and notes thereto included elsewhere in this Form 10-K.

## Selected Consolidated Financial Information

	Year ended December 31,				
	2012	2013	2014	2015	2016
	(dollars in thousands, except per share amounts)				
<b>INCOME STATEMENT DATA:</b>					
Revenues:					
Funeral	\$ 150,803	\$ 163,082	\$ 173,735	\$ 185,818	\$ 189,401
Cemetery	47,388	49,992	52,389	56,684	58,799
Total revenues	198,191	213,074	226,124	242,502	248,200
Gross profit:					
Funeral	47,260	48,874	54,102	59,434	61,620
Cemetery	13,967	15,411	15,906	18,074	18,030
Total gross profit	61,227	64,285	70,008	77,508	79,650
General and administrative expenses	24,960	27,379	30,293	28,860	29,446
Operating income	36,267	36,906	39,715	48,648	50,204
Interest expense	(17,088)	(12,622)	(10,308)	(10,559)	(11,738)
Accretion of discount on convertible subordinated notes	—	—	(2,452)	(3,454)	(3,870)
Loss on early extinguishment of debt and other costs	(3,031)	—	(1,042)	—	(567)
Loss on redemption of convertible junior subordinated debentures	—	—	(3,779)	—	—
Other, net	963	81	567	(45)	(1,788)
Income before income taxes	17,111	24,365	22,701	34,590	32,241
Provision for income taxes, net	(6,794)	(9,245)	(7,255)	(13,737)	(12,660)
Net income from continuing operations	10,317	15,120	15,446	20,853	19,581
Income from discontinued operations	1,086	4,176	392	—	—
Preferred stock dividend	14	4	—	—	—
Net income attributable to common shareholders	\$ 11,389	\$ 19,292	\$ 15,838	\$ 20,853	\$ 19,581
Earnings per share					
Basic:					
Continuing operations	\$ 0.57	\$ 0.83	\$ 0.84	\$ 1.16	\$ 1.18
Discontinued operations	0.06	0.23	0.02	—	—
Basic earnings per share	\$ 0.63	\$ 1.06	\$ 0.86	\$ 1.16	\$ 1.18
Diluted:					
Continuing operations	\$ 0.57	\$ 0.82	\$ 0.83	\$ 1.12	\$ 1.12
Discontinued operations	0.06	0.18	0.02	—	—
Diluted earnings per share	\$ 0.63	\$ 1.00	\$ 0.85	\$ 1.12	\$ 1.12
Dividends declared per share	\$ 0.100	\$ 0.100	\$ 0.100	\$ 0.100	\$ 0.150
Weighted average number of common and common equivalent shares outstanding:					
Basic	18,126	17,826	18,108	17,791	16,515
Diluted	18,226	22,393	18,257	18,317	17,460
<b>OPERATING AND FINANCIAL DATA:</b>					
Funeral homes at end of period	167	161	164	167	170
Cemeteries at end of period	33	32	32	32	32
Funeral services performed	27,864	29,854	31,402	32,627	33,160
Preneed funeral contracts sold	6,792	8,125	6,940	7,797	7,639
Backlog of preneed funeral contracts	81,585	80,714	82,842	84,353	91,402
Backlog of preneed cemetery contracts	64,580	63,453	63,322	63,178	63,254
Average revenue per funeral contract	\$ 5,347	\$ 5,365	\$ 5,453	\$ 5,621	\$ 5,642
Cremation rate	46.2%	46.9%	47.3%	48.9%	50.7%
Depreciation and amortization	\$ 9,916	\$ 11,635	\$ 11,923	\$ 13,780	\$ 15,421
<b>BALANCE SHEET DATA:</b>					
Total assets	\$ 738,085	\$ 746,599	\$ 827,528	\$ 833,139	\$ 885,069
Long-term debt, net of current maturities	163,541	142,542	152,387	195,009	204,404
Convertible junior subordinated debenture	89,770	89,770	—	—	—
Convertible subordinated notes	—	—	114,542	115,227	119,596
Stockholders' equity	134,818	155,973	179,875	157,594	177,989

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

### OVERVIEW

#### *General*

We operate in two business segments: funeral home operations, which account for approximately 76% of our revenues, and cemetery operations, which account for approximately 24% of our revenues. Funeral homes are principally service businesses that provide funeral services (traditional burial and cremation) and sell related merchandise, such as caskets and urns. Cemeteries are primarily sales businesses that sell interment rights (grave sites and mausoleum spaces) and related merchandise, such as markers and outer burial containers. We provide funeral and cemetery services and products on both an "at-need" (time of death) and "preneed" (planned prior to death) basis. At December 31, 2016, we operated 170 funeral homes in 28 states and 32 cemeteries in 11 states within the United States. For additional discussion about our overall business strategy, see Part I, Item 1, Business, Business Strategy.

#### *Funeral and Cemetery Operations*

Factors affecting our funeral operating results include: demographic trends relating to population growth and average age, which impact death rates and number of deaths; establishing and maintaining leading market share positions supported by strong local heritage and relationships; effectively responding to increasing cremation trends by selling complementary services and merchandise; controlling salary and merchandise costs; and exercising pricing leverage related to our at-need business to increase average revenue per contract. In simple terms, volume and price are the two variables that affect funeral revenues. The average revenue per contract is influenced by the mix of traditional and cremation services because our average cremation service revenue is approximately one-third of the average revenue earned from a traditional burial service. Funeral homes have a relatively fixed cost structure. Thus, small changes in revenues, up or down, normally cause significant changes to our profitability.

Our funeral contract volumes, including contracts from acquisitions, have increased from 27,864 in 2012 to 33,160 in 2016 (compound annual increase of 4.4%). Our funeral operating revenue, excluding financial revenue, has increased from \$143.2 million in 2012 to \$180.6 million in 2016 (compound annual increase of 6.0%). The increases are primarily a result of businesses we have acquired in the last five years and our ability to increase the average revenue per funeral through expanded service offerings and packages. Additional funeral revenue from preneed commissions and preneed funeral trust earnings has increased from \$7.6 million in 2012 to \$8.8 million in 2016. We experienced a 1.9% decrease in volumes in comparing the year ended December 31, 2016 to the year ended December 31, 2015 on a same store basis and the same store average revenue per contract for the year ended December 31, 2016 decreased 0.1% compared to the year ended December 31, 2015.

The percentage of funeral services involving cremations has increased from 46.2% for the year ended December 31, 2012 to 50.7% for the year ended December 31, 2016. On a same store basis, the cremation rate has risen from 46.3% in 2012 to 51.8% for the year ended December 31, 2016, while the cremation rate for our acquired funeral home businesses has risen from 43.5% for the year ended December 31, 2012 compared to 46.0% for the year ended December 31, 2016.

Cemetery operating results are affected by the size and success of our sales organization. Approximately 48.0% and 50.0% of our cemetery revenues related to preneed sales of interment rights and related merchandise and services for the years ended December 31, 2015 and 2016, respectively. We believe that changes in the economy and consumer confidence affect the amount of preneed cemetery operating revenues. Our cemetery financial performance from 2012 through 2016 was characterized by increasing levels of operating revenues and field-level cemetery profit margins. Cemetery operating revenue, excluding financial revenue, increased from \$38.3 million in 2012 to \$48.9 million in 2016 (compound annual increase of 6.3%) and increased 4.9% over 2015. Additional cemetery revenue from preneed finance charges and trust earnings has increased from \$9.1 million in 2012 to \$9.9 million in 2016 (compound annual increase of 2.0%). Changes in the capital markets and interest rates affect this component of our cemetery revenues. Our goal is to build broader and deeper teams of sales leaders and counselors in our larger and more strategically located cemeteries in order to focus on growth of our preneed property sales. Additionally, a portion of our capital expenditures is designed to continually expand our cemetery product offerings.

#### *Financial Revenue*

Income recognized from the investments in the preneed funeral trust funds, the cemetery merchandise and services trust funds and the perpetual care trust funds decreased \$1.1 million, or 6.7% for the year ended December 31, 2016, as compared to 2015, as a result of fewer preneed contract maturities and lower average revenue per preneed contract. For the five year period ended December 31, 2016, the performance of the funds, which includes realized income and unrealized appreciation, resulted in a 66.3% return. Investment income realized in the perpetual care trust funds (except for capital gains) is recognized as income when earned in the portfolio. Investment income realized in the preneed funeral trust funds and the cemetery merchandise and services trust funds is allocated to the individual preneed contracts and deferred from revenue until the time that the services and merchandise are delivered to the customer.

### *Acquisitions*

During 2016, we acquired six funeral home businesses, two in Houston, Texas, one in Madera, California, one in Brookfield, Wisconsin, one in Burlington, North Carolina and one in Graham, North Carolina for the aggregate purchase price of approximately \$32.8 million. The purchase price for the businesses consisted of approximately (i) \$23.9 million paid in cash at closing and (ii) \$8.9 million, the net present value of future deferred payments totaling \$13.5 million. In 2015, we acquired two funeral home businesses, one in Clarksville, Tennessee and one in Wake Forest, North Carolina, for the aggregate purchase price of approximately \$15.0 million.

## **OVERVIEW OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The preparation of the Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate estimates and judgments, including those related to revenue recognition, realization of accounts receivable, inventories, goodwill, other intangible assets, property and equipment and deferred tax assets and liabilities. We base our estimates on historical experience, third party data and assumptions that we believe to be reasonable under the circumstances. The results of these considerations form the basis for making judgments about the amount and timing of revenues and expenses, the carrying value of assets and the recorded amounts of liabilities. Actual results may differ from these estimates and such estimates may change if the underlying conditions or assumptions change. Historical performance should not be viewed as indicative of future performance because there can be no assurance the margins, operating income and net earnings, as a percentage of revenues, will be consistent from year to year.

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our Consolidated Financial Statements presented herewith, which have been prepared in accordance with United States generally accepted accounting principles ("GAAP"). Our significant accounting policies are more fully described in Part II, Item 8, Financial Statements and Supplementary Data, Note 1. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our Consolidated Financial Statements.

### *Funeral and Cemetery Operations*

We record the revenue from sales of funeral and cemetery merchandise and services when the merchandise is delivered or the service is performed. Sales of cemetery interment rights are recorded as revenue in accordance with the retail land sales provisions for accounting for sales of real estate. This method provides for the recognition of revenue in the period in which the customer's cumulative payments exceed 10% of the contract price related to the interment right. Costs related to the sales of interment rights, which include real property and other costs related to cemetery development activities, are charged to operations using the specific identification method in the period in which the sale of the interment right is recognized as revenue. Sales taxes collected are recognized on a net basis in our Consolidated Financial Statements.

Allowances for bad debts and customer cancellations are provided at the date that the sale is recognized as revenue and are based on our historical experience and the current economic environment. We also monitor changes in delinquency rates and provide additional bad debt and cancellation reserves when warranted.

When preneed sales of funeral services and merchandise are funded through third-party insurance policies, we earn a commission on the sale of the policies. Insurance commissions are recognized as revenues at the point at which the commission is no longer subject to refund, which is typically one year after the policy is issued. Preneed selling costs consist of sales commissions that we pay our sales counselors and other direct related costs of originating preneed sales contracts. These costs are expensed as incurred.

### *Preneed Contracts*

We sell interment rights, merchandise and services prior to the time of need, which is referred to as preneed. In many instances the customer pays for the preneed contract over a period of time. Cash proceeds from preneed sales less amounts that we may retain under state regulations are deposited to a trust or used to purchase a third-party insurance policy. The principal and accumulated earnings of the trusts are generally withdrawn at maturity (death) or cancellation. The cumulative trust income earned and the increases in insurance benefits on the insurance products are deferred until the service is performed. The customer receivables and amounts deposited in trusts that we control are primarily included in the non-current asset section of our Consolidated Balance Sheets. The preneed funeral contracts secured by third party insurance policies are not recorded as assets or liabilities of the Company.

In the opinion of management, the proceeds from the trust funds and the insurance policies at the time the preneed contracts mature will exceed the estimated future costs to perform services and provide products under such arrangements. The types of securities in which the trusts may invest are regulated by state agencies.

### *Preneed Funeral and Cemetery Trust Funds*

Our preneed and perpetual care trust funds are reported in accordance with the principles of consolidating Variable Interest Entities (“VIE’s”). In the case of preneed trusts, the customers are the legal beneficiaries of the trusts. In the case of perpetual care trusts, we do not have a right to access the corpus in the perpetual care trusts. We have recognized financial interests of third parties in the trust funds in our financial statements as *Deferred preneed funeral and cemetery receipts held in trust* and *Care trusts’ corpus*. The investments of such trust funds are classified as available-for-sale and are reported at fair market value; therefore, the unrealized gains and losses, as well as accumulated and undistributed income and realized gains and losses are recorded to *Deferred preneed funeral and cemetery receipts held in trust* and *Care trusts’ corpus* on our Consolidated Balance Sheets. Our future obligations to deliver merchandise and services are reported at estimated settlement amounts. Preneed funeral and cemetery trust investments are reduced by the trust investment earnings that we have been allowed to withdraw in certain states prior to maturity. These earnings, along with preneed contract collections not required to be placed in trust, are recorded in *Deferred preneed funeral revenue* and *Deferred preneed cemetery revenue* until the service is performed or the merchandise is delivered.

In accordance with respective state laws, we are required to deposit a specified amount into perpetual and memorial care trust funds for each interment/entombment right and certain memorials sold. Income from the trust funds is distributed to us and used to provide for the care and maintenance of the cemeteries and mausoleums. Such trust fund income is recognized as revenue when realized by the trust and distributable to us. We are restricted from withdrawing any of the principal balances of these funds.

An enterprise is required to perform an analysis to determine whether the enterprise’s variable interest(s) give it a controlling financial interest in a VIE. This analysis identifies the primary beneficiary of a VIE as the enterprise that has both the power to direct the activities of the VIE that most significantly impact the entity’s economic performance and the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. Our analysis continues to support our position as the primary beneficiary in the majority of our funeral and cemetery trust funds.

Trust management fees are earned by us for investment management and advisory services that are provided by our wholly-owned registered investment advisor (“CSV RIA”). As of December 31, 2016, CSV RIA provided these services to two institutions, which have custody of 79% of our trust assets, for a fee based on the market value of trust assets. Under state trust laws, we are allowed to charge the trust a fee for advising on the investment of the trust assets and these fees are recognized as income in the period in which services are provided.

We determine whether or not the assets in the preneed trusts have an other-than-temporary impairment on a security-by-security basis. This assessment is made based upon a number of criteria including the length of time a security has been in a loss position, changes in market conditions and concerns related to the specific issuer. If a loss is considered to be other-than-temporary, the cost basis of the security is adjusted downward to its fair market value. Any reduction in the cost basis of the investment due to an other-than-temporary impairment is likewise recorded as a reduction to *Deferred preneed funeral and cemetery receipts held in trust* and *Care trusts’ corpus* on our Consolidated Balance Sheets. There will be no impact on earnings unless and until such time that the investment is withdrawn from the trust in accordance with state regulations at an amount that is less than its original basis.

See Part II, Item 8, Financial Statements and Supplementary Data, Notes 6 and 10 for additional related disclosures.

### *Long-Lived Assets*

Long-lived assets, such as property, plant and equipment subject to depreciation and amortization, are reviewed for impairment at least annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with the Property, Plant and Equipment Topic of the Accounting Standards Codification (“ASC”) 360. This guidance requires that long-lived assets to be held and used are reported at the lower of their carrying amount or fair value. We assess long-lived assets for impairment whenever events or circumstances indicate that the carrying value may be greater than the fair value. We evaluate our long-lived assets for impairment when a funeral home business has negative EBITDA for four consecutive years and if there has been a decline in EBITDA in that same period. For our cemetery business, we analyze the long-lived assets for impairment if the business has a negative operating margin and a decline in operating margin over a four year period. We review our long-lived assets deemed held-for-sale to the point of recoverability. Assets to be disposed of and assets not expected to provide any future service potential are recorded at the lower of their carrying amount or fair value less estimated cost to sell. If we determine that the carrying value is not recoverable from the proceeds of the sale, we record an impairment at that time. For the year ended December 31, 2016, no impairments were identified on our long-lived assets.

See Part II, Item 8, Financial Statements and Supplementary Data, Note 1 for additional information.

## *Business Combinations*

Tangible and intangible assets acquired and liabilities assumed are recorded at fair value and goodwill is recognized for any difference between the price of the acquisition and fair value. We recognize the assets acquired, the liabilities assumed and any non-controlling interest in the acquiree at the acquisition date, measured at the fair value as of that date. Acquisition related costs are recognized separately from the acquisition and are expensed as incurred. We customarily estimate related transaction costs known at closing. To the extent that information not available to us at the closing date subsequently becomes available during the allocation period, we may adjust goodwill, intangible assets, assets or liabilities associated with the acquisition.

See Part II, Item 8, Financial Statements and Supplementary Data, Note 3 for additional information.

## *Goodwill*

The excess of the purchase price over the fair value of identifiable net assets of funeral home businesses acquired is recorded as goodwill. Goodwill has primarily been recorded in connection with the acquisition of funeral home businesses. Goodwill is tested annually for impairment by assessing the fair value of each of our reporting units. The funeral segment reporting units consist of our East, Central and West regions in the United States and we performed our annual impairment test of goodwill using information as of August 31, 2016.

Under current guidance, we are permitted to first assess qualitative factors to determine whether it is more-likely-than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. We conducted qualitative assessments in 2014 and 2015; however, for our 2016 annual impairment test, we performed the two-step goodwill impairment test. Our intent is to perform the two-step test at least once every three years unless certain indicators or events suggest otherwise.

The two-step goodwill impairment test involves estimates and management judgment. In the first step of our goodwill impairment testing, we compare the fair value of each reporting unit to its carrying value, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, the goodwill of that reporting unit is not considered impaired, and the second step is not required. We determine fair value for each reporting unit using both an income approach, weighted 90%, and a market approach, weighted 10%. Our methodology for determining an income-based fair value was based on discounting projected future cash flows. The projected future cash flows include assumptions concerning future operating performance and economic condition that may differ from actual future cash flows discounted at a weighted average cost of capital for the Company based on market participant assumptions. Our methodology for determining a market approach fair value utilized the guideline public company method, in which we relied on market multiples of comparable companies operating in the same industry as the individual reporting units. In accordance with the guidance, if the fair value of the reporting unit is less than its carrying amount, the second step of the goodwill impairment testing needs to be performed. This step compares the implied fair value of goodwill to the carrying amount of the reporting unit's goodwill, and if the carrying amount exceeds the implied value, an impairment charge is recorded in an amount equal to the difference. For our 2016 annual impairment test, we performed the first step of our goodwill impairment testing and concluded that there was no impairment to goodwill for any of our reporting units.

In addition to our annual review, we assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value of a reporting unit may be greater than fair value. Factors that could trigger an interim impairment review include, but are not limited to, significant adverse changes in the business climate which may be indicated by a decline in our market capitalization or decline in operating results.

For the year ended December 31, 2014, we recognized an impairment of approximately \$1.2 million for discontinued locations as the carrying value exceeded fair value. Upon receipt of a letter of intent to sell a location, we perform an analysis to determine if the net assets of the location exceed the sales price. If the net assets exceed the sales price, we record an impairment at the location level.

No impairments were recorded to our goodwill during the years ended December 31, 2015 and 2016. No such events or changes occurred between the testing date and year end to trigger a subsequent impairment review.

See Part II, Item 8, Financial Statements and Supplementary Data, Note 4 for additional information.

## *Intangible Assets*

Our intangible assets include tradenames resulting from acquisitions and are included in *Deferred costs and other non-current assets* on our Consolidated Balance Sheets. Our tradenames are considered to have an indefinite life and are not subject to amortization.

Under current guidance, we are permitted to first assess qualitative factors to determine whether it is more-likely-than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further



action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount in accordance with the guidance.

The Company elected to change the annual assessment date for indefinite lived intangible assets from December 31<sup>st</sup> to August 31<sup>st</sup> in 2016 because the change in date aligns with the Company's goodwill impairment test, which should create a synergy and enhance the quality of our indefinite lived intangible assets impairment analysis. We conducted qualitative assessments in 2014 and 2015; however, for our 2016 annual impairment test, we performed our quantitative impairment test using the relief from royalty method, using information as of August 31, 2016. Our intent is to perform the quantitative impairment test at least once every three years unless certain indicators or events suggest otherwise.

Our intangible asset impairment test involves estimates and management judgment. Under the relief from royalty method, the value of the tradename is measured through the value of the royalties that the Company is relieved from paying due to its ownership of the asset. We determine the fair value of the assets by discounting the cash flows that represent a savings in lieu of paying a royalty fee for use of the tradename. The discounted cash flow valuation uses projections of future cash flows and includes assumptions concerning future operating performance and economic conditions that may differ from actual future cash flows and the determination and application of an appropriate royalty rate and discount rate. To estimate the royalty rates for the individual tradename, we mainly relied on the profit split method, but also considered the comparable third-party license agreements and the return on asset method. A scorecard was used to assess the relative strength of the individual tradename to further adjust the royalty rates selected under the profit-split method for qualitative factors. For our 2016 annual impairment test, we performed our quantitative impairment testing and concluded that there was no impairment to intangible assets.

In addition to our annual review, we assess the impairment of intangible assets whenever certain events or changes in circumstances indicate that the carrying value of the intangible asset may be greater than the fair value. Factors that could trigger an interim impairment review include, but are not limited to, significant under-performance relative to historical or projected future operating results and significant negative industry or economic trends. During the third quarter of 2016, we recorded an impairment to tradenames of \$145,000 related to a funeral home business held for sale as the carrying value exceeded fair value. No other impairments were recorded to our intangible assets during the years ended December 31, 2014, 2015 and 2016.

See Part II, Item 8, Financial Statements and Supplementary Data, Note 12 for additional information.

#### *Divested and Discontinued Operations*

Effective January 1, 2015, we adopted the Financial Accounting Standards Board's ("FASB") guidance for reporting discontinued operations, which amended the definition of "discontinued operations" to include only disposals or held-for-sale classifications for components or groups of components of an entity that represent a strategic shift that either has or will have a major effect on an entity's operations or financial results. Examples of a strategic shift that has or will have a major effect on an entity's operations and financial results include a disposal of a major geographical area, line of business, equity method of investment or other parts of an entity. The new guidance also requires the disclosure of pre-tax income of disposals that do not qualify as discontinued operations.

During 2014, we sold a cemetery in Florida and two funeral homes, one in Ohio and one in Kentucky. For the year ended December 31, 2014, we recognized income from discontinued operations of \$0.4 million. We did not divest any of our funeral home or cemetery businesses in 2015. During 2016, we sold a funeral home business in Tennessee for \$1.35 million. The operating results of this business, as well as the loss on the sale are included within net income from continuing operations on our Consolidated Statements of Operations.

We continually review locations to optimize the sustainable earning power and return on our invested capital. These reviews could entail selling certain non-strategic businesses.

See Part II, Item 8, Financial Statements and Supplementary Data, Notes 5 for additional information.

#### *Fair Value Measurements*

We measure the available-for-sale securities held by our funeral merchandise and service, cemetery merchandise and service, and cemetery perpetual care trusts at fair value on a recurring basis in accordance with the Fair Value Measurements Topic of the ASC. This guidance defines fair value as the price that would be received in the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The guidance establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:



- Level 1 — inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets;
- Level 2 — inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument; and
- Level 3 — inputs to the valuation methodology are unobservable and significant to the fair value measurement.

We disclose the extent to which fair value is used to measure financial assets and liabilities, the inputs utilized in calculating valuation measurements, and the effect of the measurement of significant unobservable inputs on earnings, or changes in net assets, as of the measurement date. The fair value disclosures of transfers in and out of Levels 1 and 2 and the gross presentation of purchases, sales, issuances and settlements in the Level 3 reconciliation of the three-tier fair value hierarchy are also presented in Notes 6 and 10 to the Consolidated Financial Statements included herein. We currently do not have any assets that have fair values determined by Level 3 inputs and no liabilities measured at fair value. We have not elected to measure any additional financial instruments and certain other items at fair value that are not currently required to be measured at fair value.

To determine the fair value of assets and liabilities in an environment where the volume and level of activity for the asset or liability have significantly decreased, the exit price is used as the fair value measurement. For the year ended December 31, 2016, we did not incur significant decreases in the volume or level of activity of any asset or liability. We consider an impairment of debt and equity securities other-than-temporary unless (a) we have the ability and intent to hold an investment and (b) evidence indicating the cost of the investment is recoverable before we are more likely than not required to sell the investment. If an impairment is indicated, then an adjustment is made to reduce the carrying amount to fair value which is recorded as a reduction to either *Deferred preneed cemetery receipts held in trust*, *Deferred preneed funeral receipts held in trust* or *Care trusts' corpus* on our Consolidated Balance Sheets. For the years ended December 31, 2015 and 2016, we recorded impairment charges of \$1.8 million and \$2.3 million, respectively, for other-than-temporary declines in fair value related to unrealized losses on certain investments.

In the ordinary course of business, we are typically exposed to a variety of market risks. Currently, these are primarily related to changes in fair market values related to outstanding debts and changes in the values of securities associated with the preneed and perpetual care trusts. Management is actively involved in monitoring exposure to market risk and developing and utilizing risk management techniques when appropriate and when available for a reasonable price.

See Part II, Item 8, Financial Statements and Supplementary Data, Note 11 for additional information.

#### *Presentation of Debt Issuance Costs*

Effective January 1, 2016, we adopted the FASB's guidance on simplifying the presentation of debt issuance costs. The guidance requires that entities that have historically presented debt issuance costs as an asset, related to a recognized debt liability, will be required to present those costs as a direct deduction from the carrying value of the related debt liability. This presentation resulted in debt issuance costs being presented in the same way debt discounts have historically been addressed. Debt issuances costs of \$4.2 million and \$3.6 million have been presented as a deduction from the carrying value of the related liabilities in our Consolidated Balance Sheets as of December 31, 2015 and 2016, respectively. The amounts related to our Credit Facility were \$1.4 million and \$1.3 million as of December 31, 2015 and 2016, respectively. The amounts related to our Convertible Notes were \$2.8 million and \$2.3 million as of December 31, 2015 and 2016, respectively.

See Part II, Item 8, Financial Statements and Supplementary Data, Notes 13 and 14 for additional information.

#### *Income Taxes*

We and our subsidiaries file a consolidated United States Federal income tax return, separate income tax returns in 15 states in which we operate and combined or unitary income tax returns in 13 states in which we operate. We record deferred taxes for temporary differences between the tax basis and financial reporting basis of assets and liabilities. Effective January 1, 2016, we adopted the FASB's new guidance requiring that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position.

We record a valuation allowance to reflect the estimated amount of deferred tax assets for which realization is uncertain. Management reviews the valuation allowance at the end of each quarter and makes adjustments if it is determined that it is more likely than not that the tax benefits will be realized.

We analyze tax benefits for uncertain tax positions and how they are to be recognized, measured, and derecognized in the financial statements; provide certain disclosures of uncertain tax matters; and specify how reserves for uncertain tax positions should be classified on the Consolidated Balance Sheets.

On August 1, 2014, we received notification that the Internal Revenue Service (“IRS”) completed its examination of our tax year ended December 31, 2011. As a result, we recognized a tax benefit of \$1.7 million which reduced our effective tax rate for the year ended December 31, 2014. Additionally, we recognized a credit to interest expense of \$0.6 million related to the settled portion of the uncertain tax position.

On August 15, 2016, we settled an open examination with the California Franchise Tax Board. As a result of paying the final assessment, we re-measured our tax liability for unrecognized tax benefits reflecting a reduction to our liability of \$0.2 million. On August 29, 2016, we received notification that the IRS completed its examination of our tax year ended December 31, 2013. As a result, we re-measured our tax liability for unrecognized tax benefits reflecting a reduction to our liability of \$0.6 million, which resulted in an increase to *Deferred tax liability* in the amount of \$0.6 million.

We do not have any unrecognized tax benefits recorded as of December 31, 2016 and we do not anticipate a material change in our unrecognized tax benefits during the next twelve months.

Effective January 1, 2016, we adopted the FASB’s guidance on Balance Sheet Classification of Deferred Taxes. The standard simplifies deferred tax reporting on the balance sheet by eliminating non-current and current classifications. The guidance requires all deferred tax assets and liabilities, along with related valuation allowances will be classified as non-current on the balance sheet. The guidance was applied prospectively and all deferred tax assets and liabilities, along with our valuation allowance are now classified as non-current at December 31, 2016.

See Part II, Item 8, Financial Statements and Supplementary Data, Note 16 for additional information.

#### *Stock Plans and Stock-Based Compensation*

We have stock-based employee and director compensation plans under which we may grant restricted stock, stock options, performance awards and our employee stock purchase plan under which stock may be purchased. We recognize compensation expense in an amount equal to the fair value of the share-based awards expected to vest over the requisite service period. Fair value is determined on the date of the grant. The fair value of options or awards containing options is determined using the Black-Scholes valuation model. The fair value of the performance awards is determined using a Monte-Carlo simulation pricing model.

See Part II, Item 8, Financial Statements and Supplementary Data, Note 17 for additional information.

#### *Computation of Earnings per Common Share*

Basic earnings per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares consist of stock options and our Convertible Notes.

Share-based awards that contain non-forfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are recognized as participating securities and included in the computation of both basic and diluted earnings per share. Our grants of restricted stock awards to our employees and directors are considered participating securities, and we have prepared our earnings per share calculations attributable to common stockholders to exclude outstanding unvested restricted stock awards, using the two-class method, in both the basic and diluted weighted average shares outstanding calculation.

The fully diluted weighted average shares outstanding for the years ended December 31, 2015 and 2016, and the corresponding calculation of fully diluted earnings per share, included approximately 0.3 million and 0.5 million shares that would have been issued upon the conversion of our convertible subordinated notes as a result of the application of the if-converted method prescribed by the FASB ASC 260. There were no shares that would have been issued upon conversion under the if-converted method for our convertible subordinated notes for the year ended December 31, 2014.

The calculations for basic and diluted earnings per share for the three years ended December 31, 2014, 2015 and 2016 are presented in Part II, Item 8, Financial Statements and Supplementary Data, Note 19.

#### *Subsequent Events*

We have evaluated events and transactions during the period subsequent to December 31, 2016 through the date the financial statements were issued for potential recognition or disclosure in the accompanying financial statements covered by this report.

## RECENT ACCOUNTING PRONOUNCEMENTS, ACCOUNTING CHANGES AND OTHER REGULATIONS

### *Goodwill*

In January 2017, the FASB issued ASU, *Intangibles – Goodwill and Other (Topic 350)*. This ASU applies to all entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. The amendment simplifies subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test, which should reduce the cost and complexity of evaluating goodwill for impairment. An entity no longer will determine goodwill impairment by calculating the implied fair value of goodwill by assigning the fair value of a reporting unit to all of its assets and liabilities as if that reporting unit had been acquired in a business combination. Instead, impairment is defined as the amount by which the carrying value of the reporting unit exceeds its fair value, up to the total amount of goodwill. This ASU is effective for fiscal years beginning after December 15, 2019, with early adoption permitted. Our adoption of this ASU for our fiscal year beginning January 1, 2017 is not expected to have a material effect on our Consolidated Financial Statements.

### *Stock-Based Compensation*

In March 2016, the FASB issued ASU, *Compensation – Stock Compensation (Topic 718)*. This ASU applies to all entities that issue share-based payment awards to their employees. The amendments in this ASU involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with earlier application permitted for all entities. Amendments related to the presentation of employee taxes paid on the statement of cash flows when an employer withholds shares to meet the minimum statutory withholding requirement should be applied retrospectively. Amendments requiring recognition of excess tax benefits and tax deficiencies in the income statement and the practical expedient for estimating expected term should be applied prospectively. An entity may elect to apply the amendments related to the presentation of excess tax benefits on the statement of cash flows using either a prospective transition method or a retrospective transition method. Our adoption of this ASU for our fiscal year beginning January 1, 2017 is not expected to have a material effect on our Consolidated Financial Statements.

### *Inventory*

In July 2015, the FASB issued ASU, *Inventory – Simplifying the Measurement of Inventory (Topic 330)*. This ASU applies to all inventory, including inventory that is measured using the first-in, first-out (FIFO) or average cost method. This ASU does not apply to the last-in, first-out (LIFO) or the retail inventory method. This ASU requires an entity to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. This ASU is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years, and should be applied prospectively, with earlier application permitted as of the beginning of an interim or annual reporting period. Our adoption of this ASU for our fiscal year beginning January 1, 2017 is not expected to have a material effect on our Consolidated Financial Statements.

### *Revenue Recognition*

In May 2014, the FASB issued ASU, *Revenue from Contracts with Customers. (Topic 606)*. ASC Topic 606 supersedes the revenue recognition requirements under ASC Topic 605, *Revenue Recognition*, and most industry-specific guidance throughout the Industry Topics of the ASC. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. Under the new guidance, an entity is required to perform the following five steps: (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the entity satisfies a performance obligation. The new guidance will significantly enhance comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. Additionally, the guidance requires improved disclosures as to the nature, amount, timing and uncertainty of revenue that is recognized. On July 9, 2015, the FASB deferred the effective date by one year to annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2018.

We expect the adoption of this new accounting standard to affect our accounting for cemetery interment rights. Currently, our sales of cemetery interment rights are recorded as revenue in accordance with the retail land sales provisions for accounting for sales of real estate. This method provides for the recognition of revenue in the period in which the customer's cumulative payments exceed 10% of the contract price related to the interment right.

Under the new accounting standard, we will recognize the revenue in the period in which the sale occurs, irrespective of the cumulative payments received. The impact of this is not expected to have a material impact on our Consolidated Financial Statements. Upon revenue recognition, management will book an allowance for contract cancellations based on our previous

experience of cancellations and as such will reflect a one-time catch up for the allowance at January 1, 2018, which is not expected to have a material impact on our Consolidated Financial Statements.

Costs related to the sales of interment rights, which include real property and other costs related to cemetery development activities, will continue to be charged to operations using the specific identification method in the period in which the sale of the interment right is recognized as revenue. We do not expect the adoption of this accounting standard to materially affect our accounting for other revenue streams.

We are currently modifying our financial systems to provide accounting under the new method in addition to our current method and do not anticipate any business disruption related to adopting this guidance. We are continually evaluating the impact on our Consolidated Financial Statements with more recent financial information.

#### *Cash Flows*

In August 2016, the FASB issued ASU, *Statement of Cash Flows (Topic 230)*. This ASU applies to all entities that are required to present a statement of cash flows under Topic 230. The amendments provide guidance on eight specific cash flow issues and includes clarification on how these items should be classified in the statement of cash flows and is designed to help eliminate diversity in practice as to where items are classified in the cash flow statement.

In November 2016, the FASB issued additional guidance on this Topic that requires amounts generally described as restricted cash and restricted cash equivalents to be included with cash and cash equivalents when reconciling the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years, with earlier application permitted for all entities. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2018 and are currently evaluating the impact the adoption of this new accounting standard will have on our Consolidated Financial Statements.

#### *Business Combinations*

In January 2017, the FASB issued Accounting Standards Update (“ASU”), *Business Combinations – Clarifying the Definition of a Business (Topic 805)*. This ASU applies to all entities that must determine whether they have acquired or sold a business. The amendments in this Update clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. This ASU is effective for fiscal years beginning after December 15, 2017, including the interim periods within those periods, with earlier application permitted. Our adoption of this ASU for our fiscal year beginning January 1, 2018 is not expected to have a material effect on our Consolidated Financial Statements.

#### *Leases*

In February 2016, the FASB issued ASU, *Leases (Topic 842)*. This ASU addresses certain aspects of recognition, presentation, and disclosure of leases and applies to all entities that enter into a lease, with some specified scope exemptions. The amendments in this ASU aim to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with earlier application permitted for all entities. Both lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach, which recognizes the cumulative effect of initially applying the standard as an adjustment to retained earnings at the date of initial application. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2019 and are currently evaluating the impact the adoption of this new accounting standard will have on our Consolidated Financial Statements.

#### *Financial Instruments*

In January 2016, the FASB issued ASU, *Financial Instruments – Overall - Recognition and Measurement of Financial Assets and Financial Liabilities (Topic 825)*. The amendments in this ASU address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and apply to all entities that hold financial assets or owe financial liabilities. The amendments in this ASU also simplify the impairment assessment of equity investments without readily determinable fair values by requiring assessment for impairment qualitatively at each reporting period. That impairment assessment is similar to the qualitative assessment for long-lived assets, goodwill, and indefinite-lived intangible assets. This ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, with earlier application permitted for financial statements that have not been issued. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2018 and are currently evaluating the impact the adoption of this new accounting standard will have on our Consolidated Financial Statements.

In June 2016, the FASB issued ASU, *Financial Instruments – Credit Losses (Topic 326)*. This ASU applies to all entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The main objective of the ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. This amendment replaces the incurred loss impairment methodology in the current standard with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. This ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years, with earlier application permitted for all entities. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2020 and are currently evaluating the impact the adoption of this new accounting standard will have on our Consolidated Financial Statements.

## SELECTED INCOME AND OPERATIONAL DATA

The following table sets forth certain income statement data for us expressed as a percentage of net revenues for the periods presented:

	Year Ended December 31,		
	2014	2015	2016
Total gross profit	31.0%	32.0%	32.1%
General and administrative expenses	13.4%	11.9%	11.9%
Operating income	17.6%	20.1%	20.2%
Interest expense	4.6%	4.4%	4.7%

The following table sets forth the number of funeral homes and cemeteries owned and operated by us for the periods presented:

	Year Ended December 31,		
	2014	2015	2016
Funeral homes at beginning of period	161	164	167
Acquisitions	6	2	6
Constructed funeral homes	—	3	—
Divestitures	(2)	—	(1)
Mergers and relocation of funeral homes	(1)	(2)	(2)
Funeral homes at end of period	164	167	170
Cemeteries at beginning of period	32	32	32
Acquisitions	1	—	—
Divestitures	(1)	—	—
Cemeteries at end of period	32	32	32

## REPORTING AND NON-GAAP FINANCIAL MEASURES

We also present our financial performance in our “Operating and Financial Trend Report” (“Trend Report”) as reported in our earnings release for the year ending December 31, 2016 dated February 15, 2017 and discussed in the corresponding earnings conference call. This Trend Report is used as a supplemental financial measurement statement by management and investors to compare our current financial performance with our previous results and with the performance of other companies. We do not intend for this information to be considered in isolation or as a substitute for other measures of performance prepared in accordance with United States generally accepted accounting principles (“GAAP”). The Trend Report is a non-GAAP statement that also provides insight into underlying trends in our business.

Historically, the dynamic nature of the evolutionary process of building our culture, especially since launching the **Good To Great Journey** in the beginning of 2012, has led to a large number of charges such as severance and retirement, consulting and other activities, which are not core to our operations and as such, have been added back to GAAP earnings as “Special Items”. The Special Items are important to add back because of the transformational nature of major changes over the last several years within our Operations and Strategic Growth Leadership Team, culminating during 2015 in a reduction from fifteen members to nine members and most recently to eight members due to the retirement of David J. DeCarlo, effective September 30, 2016. The number of these Special Items should be minimal during 2016 and thereafter.



Accordingly, beginning in the first quarter of 2016, these non-GAAP Special Items will be comprised of only those charges materially outside the normal course of business, which should result in major shrinkage of “the gap” between our GAAP and non-GAAP reported performance.

The non-GAAP financial measures in the Trend Report include such measures as “Special Items,” “Adjusted Net Income,” “Consolidated EBITDA,” “Adjusted Consolidated EBITDA,” “Adjusted Consolidated EBITDA Margin,” “Adjusted Free Cash Flow,” “Funeral, Cemetery and Financial EBITDA,” “Total Field EBITDA,” “Total Field EBITDA Margin,” “Adjusted Basic Earnings Per Share” and “Adjusted Diluted Earnings Per Share”. These financial measurements are defined as GAAP items adjusted for Special Items and are reconciled to GAAP in our earnings release and on the Trend Reports posted on our website ([www.carriageservices.com](http://www.carriageservices.com)). In addition, our presentation of these measures may not be comparable to similarly titled measures in other companies’ reports.

The non-GAAP definitions we use are as follows:

- Special Items are defined as charges or credits included in our GAAP financial statements that can vary from period to period and are not reflective of costs incurred in the ordinary course of our operations. Special Items are taxed at the federal statutory rate of 34 percent for the year ended December 31, 2015 and 35 percent for the year ended December 31, 2016, except for the accretion of the discount on the Convertible Notes as this is a non-tax deductible item and the tax adjustment from prior period.
- Adjusted Net Income is defined as net income plus adjustments for Special Items.
- Consolidated EBITDA is defined as net income before income taxes, interest expenses, non-cash stock compensation, depreciation and amortization, and interest income and other, net.
- Adjusted Consolidated EBITDA is defined as Consolidated EBITDA plus adjustments for Special Items.
- Adjusted Consolidated EBITDA Margin is defined as Adjusted Consolidated EBITDA as a percentage of revenue.
- Adjusted Free Cash Flow is defined as net cash provided by operations, adjusted by cash-related Special Items, less cash for maintenance capital expenditures.
- Funeral Field EBITDA is defined as Funeral Gross Profit, which is funeral revenue minus funeral field costs and expenses, less depreciation and amortization, regional and unallocated funeral overhead expenses and Funeral Financial EBITDA.
- Cemetery Field EBITDA is defined as Cemetery Gross Profit, which is cemetery revenue minus cemetery field costs and expenses, less depreciation and amortization, regional and unallocated cemetery overhead expenses and Cemetery Financial EBITDA.
- Funeral Financial EBITDA is defined as Funeral Financial Revenue less Funeral Financial Expenses.
- Cemetery Financial EBITDA is defined as Cemetery Financial Revenue less Cemetery Financial Expenses.
- Total Field EBITDA is defined as Gross Profit less depreciation and amortization, regional and unallocated overhead expenses.
- Total Field EBITDA Margin is defined as Total Field EBITDA as a percentage of revenue.
- Adjusted Basic Earnings Per Share is defined as GAAP Basic Earnings Per Share, adjusted for Special Items.
- Adjusted Diluted Earnings Per Share is defined as GAAP Diluted Earnings Per Share, adjusted for Special Items.

The non-GAAP Withdrawable Trust Income in our Trend Reports prior to 2016 reflects the change in the available income we are able to withdraw from Preened Cemetery Trusts in three states that allow cash income to be withdrawn prior to maturity of the contract. The intent of this presentation was to show the true cash earning power of our Company. However, the amount of reported Withdrawable Trust Income has been steadily declining over the past years while our Adjusted Consolidated EBITDA and Adjusted Consolidated EBITDA Margin have been materially increasing. As its financial impact is diminishing and the intrinsic value of reporting such non-GAAP affect is insignificant, we will no longer reflect Withdrawable Trust Income within the Special Items section of our Trend Reports.



Below is a reconciliation of Net Income (a GAAP measure) to Adjusted Net Income (a non-GAAP measure) for the years ended December 31, 2015 and 2016.

	Year Ended December 31,	
	2015	2016
	(in millions)	
Net Income	\$ 20.8	\$ 19.6
Special Items, net of tax except for items noted by**		
Withdrawable Trust Income	0.4	n/a
Acquisition and Divestiture Expenses	0.4	0.4
Severance and Retirement Costs	0.6	2.6
Consulting Fees	1.3	0.3
Accretion of Discount on Convertible Subordinated Notes**	3.5	3.9
Loss on Extinguishment of Debt	—	0.4
Net Gain/Loss on Sale of Assets	—	1.1
Other Special Items	0.2	—
Tax Adjustment from Prior Period**	0.1	—
Adjusted Net Income	<u>\$ 27.3</u>	<u>\$ 28.3</u>

## YEAR ENDED DECEMBER 31, 2016 COMPARED TO YEAR ENDED DECEMBER 31, 2015

### *Financial Highlights*

Total revenue for the year ended December 31, 2016 and 2015 was \$248.2 million and \$242.5 million, respectively, which represents an increase of approximately \$5.7 million, or 2.3%. For the year comparatives, we experienced a 1.6% increase in total funeral contracts and a slight increase in the average revenue per funeral contract of 0.4%. In addition, while we experienced a decrease of 6.3% in the number of preneed interment rights (property) sold, the average price per interment right sold increased 5.7%. Further discussion of revenue for our funeral home and cemetery segments as well as the contract mix is presented herein under “Results of Operations.”

Operating income increased \$1.6 million, or 3.2%, due primarily to better cost management in our same store funeral home operations, increases in funeral acquisition revenues as well as increases in preneed property revenue in our cemetery operations. Further discussion of operating income is presented herein under “Results of Operations” within our funeral home and cemetery segments.

Net income for the year ended December 31, 2016 decreased \$1.3 million to \$19.6 million, equal to \$1.12 per diluted share, compared to net income of \$20.8 million, equal to \$1.12 per diluted share, for the year ended December 31, 2015. Further discussion of depreciation and amortization expense, general and administrative costs, interest expense, income taxes and other components of income and expenses are presented herein under “Other Financial Statement Items.”

The following is a discussion of our results of operations for the years ended December 31, 2016 and 2015. The term “same store” or “existing operations” refers to funeral homes and cemeteries acquired prior to January 1, 2012 and owned and operated for the entirety of each period being presented. Funeral homes and cemeteries purchased after December 31, 2011 are referred to as “acquired.” This classification of acquisitions has been important to management and investors in monitoring the results of these businesses and to gauge the leveraging performance contribution that a selective acquisition program can have on total company performance. Depreciation and amortization and regional and unallocated funeral and cemetery costs are not included in operating profit.

## Results of Operations

*Funeral Home Segment.* The following table sets forth certain information regarding our revenues and operating profit from funeral home continuing operations for the year ended December 31, 2015 compared to the year ended December 31, 2016.

	Year Ended December 31,		Change	
	2015	2016	Amount	Percent
	(dollars in thousands)			
Revenues:				
Same store operating revenue	\$ 142,690	\$ 140,459	\$ (2,231)	(1.6)%
Acquired operating revenue	33,678	40,165	6,487	19.3 %
Preneed funeral insurance commissions	1,484	1,429	(55)	(3.7)%
Preneed funeral trust earnings	7,966	7,348	(618)	(7.8)%
Revenues from continuing operations	<u>\$ 185,818</u>	<u>\$ 189,401</u>	<u>\$ 3,583</u>	1.9 %
Operating profit:				
Same store operating profit	\$ 54,620	\$ 54,706	\$ 86	0.2 %
Acquired operating profit	13,693	16,536	2,843	20.8 %
Preneed funeral insurance commissions	454	682	228	50.2 %
Preneed funeral trust earnings	7,885	7,259	(626)	(7.9)%
Gross profit from continuing operations	<u>\$ 76,652</u>	<u>\$ 79,183</u>	<u>\$ 2,531</u>	3.3 %

Funeral home same store operating revenues for the year ended December 31, 2016 decreased \$2.2 million, or 1.6%, when compared to the year ended December 31, 2015. This decrease was primarily due to a 1.9% decrease in same store contract volume to 26,636, while the average revenue per contract remained flat at \$5,273. The average revenue per contract excludes the impact of preneed funeral trust earnings (separately reflected in Revenue above) recognized at the time that we provide the services pursuant to the preneed contract. Including preneed funeral trust earnings, the average revenue per contract remained flat at \$5,471 for the year ended December 31, 2016. The average revenue per burial contract increased 1.8% to \$8,819, while the number of traditional burial contracts decreased 5.6% to 10,875. The number of cremation contracts increased 1.3% to 13,801, and the average revenue per cremation contract increased 1.0% to \$3,274. The burial rate decreased 170 basis points to 40.8% and the cremation rate increased 160 basis points to 51.8% for the year ended December 31, 2016 when compared to the year ended December 31, 2015. The average revenue for “other” contracts, which are charges for merchandise and services for which we do not perform a funeral service and which make up approximately 7.4% of the total number of contracts for the year ended December 31, 2016, increased 3.1% to \$2,371.

Same store operating profit for the year ended December 31, 2016 increased \$0.1 million, or 0.2%, from the year ended December 31, 2015, despite the decrease in operating revenues. This is primarily the result of better management of expenses, which decreased \$1.5 million or 2.1% when compared to the same period in 2015. Those expenses with significant decreases include facilities and grounds expenses, which decreased by \$0.9 million, general liability and other insurance expenses, which decreased by \$0.4 million, and salaries and benefits expense, which decreased by \$0.2 million.

Funeral home acquired revenues for the year ended December 31, 2016 increased \$6.5 million, or 19.3%, when compared to the year ended December 31, 2015, as we experienced a 19.1% increase in the acquired contract volume to 6,524, while the average revenue per contract increased 0.2% to \$6,157. The average revenue per contract excludes the impact of preneed funeral trust earnings (separately reflected in Revenue above) recognized at the time that we provide the services pursuant to the preneed contract. Including funeral trust earnings, the average revenue per contract remained flat at \$6,342 for the year ended December 31, 2016. The average revenue per burial contract increased 3.4% to \$9,258, and the number of traditional burial contracts increased 10.5% to 3,012. The number of cremation contracts increased 28.3% to 3,003, and the average revenue per cremation contract increased 4.0% to \$4,110. The 2016 funeral home acquired portfolio includes six businesses acquired during 2016 not present in 2015. These businesses increased revenue by \$3.0 million and contract volume by 500 contracts in the year ended December 31, 2016.

Acquired operating profit for the year ended December 31, 2016 increased \$2.8 million, or 20.8%, from the year ended December 31, 2015. This increase is a result of an increase in revenues, offset by a \$2.9 million or 18.4% increase in expenses. The operating profit for the year ended December 31, 2016 includes \$1.1 million related to the 2016 funeral home acquired portfolio. The most significant change was in salaries and benefits (the largest controllable expense), which increased \$1.8 million, general and administrative expenses increased \$0.7 million, facilities and grounds expenses increased \$0.2 million and general

liability and other insurance expenses increased \$0.2 million. Expenses as a percentage of revenue however, remained flat for the year ended December 31, 2016 compared to the same period in 2015.

The two categories of financial revenue consist of preneed funeral insurance commission revenue and preneed funeral trust earnings on matured preneed contracts. Preneed funeral insurance commission revenue decreased by approximately \$0.1 million, or 3.7%, for the year ended December 31, 2016 as compared to the same period in 2015. Preneed funeral commission revenue is deferred for one year after the preneed funeral contracts are sold. For the year ended December 31, 2015, we sold less preneed funeral contracts for which we earn a commission than in the same period of the previous year. Preneed funeral trust earnings decreased by approximately \$0.6 million, or 7.8%, in the year ended December 31, 2016. Preneed funeral trust earnings include trust management fees charged by our wholly-owned registered investment advisor based on the fair market value of the trust assets. Operating profit for the two categories of financial revenue, on a combined basis, decreased 4.8% in the year ended December 31, 2016 compared to the same period in 2015 due primarily to the decrease in preneed funeral trust revenue.

*Cemetery Segment.* The following table sets forth certain information regarding our revenues and operating profit from the cemetery continuing operations for the year ended December 31, 2015 compared to the year ended December 31, 2016:

	Year Ended December 31,		Change	
	2015	2016	Amount	Percent
	(dollars in thousands)			
Revenues:				
Same store operating revenue	\$ 43,336	\$ 45,441	\$ 2,105	4.9 %
Acquired operating revenue	3,321	3,506	185	5.6 %
Cemetery trust earnings	8,440	8,004	(436)	(5.2)%
Preneed cemetery finance charges	1,587	1,848	261	16.4 %
Revenues from continuing operations	<u>\$ 56,684</u>	<u>\$ 58,799</u>	<u>\$ 2,115</u>	3.7 %
Operating Profit:				
Same store operating profit	\$ 14,045	\$ 14,499	\$ 454	3.2 %
Acquired operating profit	1,088	1,168	80	7.4 %
Cemetery trust earnings	8,167	7,715	(452)	(5.5)%
Preneed cemetery finance charges	1,587	1,848	261	16.4 %
Gross profit from continuing operations	<u>\$ 24,887</u>	<u>\$ 25,230</u>	<u>\$ 343</u>	1.4 %

Cemetery same store operating revenues for the year ended December 31, 2016 increased \$2.1 million, or 4.9%, when compared to the year ended December 31, 2015. Approximately 60% of our same store operating revenues were related to preneed sales of interment rights (property) and related merchandise and services for the year ending December 31, 2016. Preneed property revenue increased \$1.5 million, or 6.8% as we experienced a 6.1% increase in the average price per interment to \$3,169, while the number of preneed interment rights sold decreased 7.3% to 7,035 in the year ending December 31, 2016 from the same period in 2015. The increase in the average price per interment was a result of sales of higher-valued interments at gardens constructed in recent years at several of our same store locations. Same store at-need revenue, which represents approximately 40% of our same store operating revenues, increased 4.3%, primarily due to a 2.5% increase in the number of contracts to 13,322 and a 1.9% increase in the average sales per contract to \$1,369.

Cemetery same store operating profit for the year ended December 31, 2016 increased \$0.5 million, or 3.2%. As a percentage of same store revenue, cemetery same store operating profit decreased to 31.9% in the year ended December 31, 2016 from 32.4% in the same period in 2015. The increase in operating profit was primarily a result of the increase in revenue, offset by \$1.5 million or 6.1% increase in operating costs for the year ended December 31, 2016 compared with the same period in 2015. Those expenses with significant increases include \$0.7 million of promotional expenses, \$0.4 million of bad debt expense, \$0.3 million of salaries and benefits and \$0.1 million of general and administrative expenses.

Cemetery acquired revenue and operating profit increased in the year ended December 31, 2016 primarily due to a 3.8% increase in preneed property revenue, as operating costs slightly increased by \$0.1 million compared with the same period in 2015. Cemetery acquired operating profit margin increased 55 basis points to 33.31% for the year ended December 31, 2016 compared to the same period in 2015.

The two categories of financial revenue consist of trust earnings and finance charges on preneed receivables. Trust earnings also include trust management fees charged by our wholly-owned registered investment advisor based on the fair market value of the trust assets. Total trust earnings decreased 5.2% primarily due to a \$0.5 million decrease in merchandise and service trust

income in the year ended December 31, 2016 compared to the same period in 2015. Financial revenue earned from finance charges on the preneed contracts increased 16.4% in the year ended December 31, 2016 compared to the same period in 2015, primarily as a result of our increased collection efforts.

### ***Other Financial Statement Items***

*Depreciation and Amortization Costs.* Depreciation and Amortization costs for the field and home office totaled \$15.4 million for year the ended December 31, 2016, an increase of \$1.6 million, or 11.9%, compared to the year ended December 31, 2015. These increases were primarily attributable to additional depreciation expense from assets acquired in our recent acquisitions, as well as from our newly constructed funeral homes which began operating in the latter half of 2015.

*Regional and Unallocated Funeral and Cemetery Costs.* Regional and unallocated funeral and cemetery costs consist of salaries and benefits for regional management, field incentive compensation and other related costs for field infrastructure. Regional and unallocated funeral and cemetery costs decreased \$1.2 million, or 9.6%, primarily due to a \$1.1 million decrease in field incentive compensation, a \$0.2 million decrease in salaries and benefits and a \$0.1 million decrease in other administrative expenses, offset by \$0.2 million increase in severance costs.

*General, Administrative and Other:* General, administrative and other expenses totaled \$27.9 million for the year ended December 31, 2016, an increase of \$0.8 million, or 3.1%, compared to the year ended December 31, 2015. The increase was partially attributable to the retirement of two former executives as we incurred \$3.5 million in severance costs, which was offset by a \$1.2 million decrease in non-cash stock compensation expense and a \$0.7 decrease in salaries and benefits related to their retirement.

In addition, we incurred a \$0.5 million increase in acquisition and divestiture expenses, offset by other changes which include a \$0.4 million decrease in salaries and benefits, a \$0.4 million decrease in non-cash stock compensation expense, a \$0.3 million decrease in severance costs and a \$0.2 million decrease in other general and administrative expense.

*Interest Expense.* Interest expense was \$11.7 million for the year ended December 31, 2016 compared to \$10.6 million for the year ended December 31, 2015, an increase of \$1.2 million. During the year ended December 31, 2016, interest expense related to our term note and revolving credit facility increased by approximately \$1.1 million, as a result of a higher principal balance and higher interest rate during the current period. Interest expense related to deferred purchase price increased by approximately \$0.2 million, as a result of our 2016 acquisitions. These increases were offset by a \$0.1 million decrease in the amortization of debt issuance costs related to the credit facility compared to the same period in 2015.

*Accretion of Discount on Convertible Subordinated Notes.* For the year ended December 31, 2016, we recognized accretion of the discount on our convertible subordinated notes of \$3.9 million compared to \$3.5 million for the same period in 2015. Accretion is calculated using the effective interest method based on a stated interest rate of 6.75% and will increase each year through to maturity.

*Loss on Early Extinguishment of Debt.* In February 2016, we entered into the Seventh Amendment (as defined below under *Debt Obligations*) to our Credit Facility. As a result, we recognized a loss of \$0.6 million to write-off the related unamortized debt issuance costs during the year ended December 31, 2016.

*Other, net.* For the year ended December 31, 2016, we recognized a net loss of \$1.8 million on the following transactions: (i) \$1.8 million loss on the sale of land; (ii) \$0.1 million loss related to an impairment of tradenames for a funeral home business sold during the year ended December 31, 2016; offset by, (iii) \$0.1 million gain on the sale of a funeral home business and other assets.

*Income taxes.* Our income tax provision was approximately \$12.7 million for the year ended December 31, 2016 compared to \$13.7 million for the year ended December 31, 2015. Our effective tax rate was 39.7% and 39.3% for the years ended December 31, 2015 and 2016, respectively. During 2016, the re-measurement of the tax liability for unrecognized tax benefits arising from the finalization of our IRS and California Franchise Tax Board exams, resulted in a \$0.8 million reduction to our liability related to uncertain tax positions. At December 31, 2016, no uncertain tax positions were identified. See Part II, Item 8, Financial Statements and Supplementary Data, Note 16 for additional information regarding our income taxes.

## YEAR ENDED DECEMBER 31, 2015 COMPARED TO YEAR ENDED DECEMBER 31, 2014

### *Financial Highlights*

Total revenue for the year ended December 31, 2015 was \$242.5 million compared to \$226.1 million for the comparable period of 2014, an increase of \$16.4 million, or 7.2% as we experienced a 3.9% increase in total funeral contracts and a 9.6% increase in cemetery preneed property sale contracts in the year ended December 31, 2015. Operating income also increased \$8.9 million, or 22.5%, and our total field margins improved to 32.0% in 2015 from 31.0% in 2014. Further discussion of revenue and operating profit for our funeral home and cemetery segments is presented herein under “Results of Operations.” Net income from continuing operations for the year ended December 31, 2015 totaled \$20.8 million, equal to \$1.12 per diluted share, as compared to \$15.4 million for the year ended December 31, 2014, or \$0.83 per diluted share.

Income from discontinued operations, net of tax, was \$0.4 million for the year ended December 31, 2014. Effective January 1, 2015, we adopted the FASB's new guidance for reporting discontinued operations. As such, we no longer report discontinued operations unless the disposal represents a strategic shift that has a major effect on our operations and financial results. There were no divestitures of any of our funeral or cemetery businesses in 2015.

We also present our financial performance in our “Operating and Financial Trend Report” (“Trend Report”) as reported in our earnings release and discussed on our earnings call for the year ending December 31, 2015. This Trend Report is used as a supplemental financial measurement statement by management and investors to compare our current financial performance with our previous results and with the performance of other funeral and cemetery companies. The Trend Report is a Non-GAAP statement from continuing operations that also provides insight into underlying trends in our business. We do not intend for this information to be considered in isolation or as a substitute for other measures of performance prepared in accordance with GAAP.

The Non-GAAP financial measures in the Trend Report include such measures as “Adjusted Net Income,” “Adjusted Diluted Earnings Per Share,” “Consolidated EBITDA,” “Adjusted Consolidated EBITDA,” “Funeral, Cemetery and Financial EBITDA” and “Total Field EBITDA. These financial measurements are defined as GAAP items adjusted for Special Items and are reconciled to GAAP in our earnings release and on the Trend Reports posted on our website ([www.carriageservices.com](http://www.carriageservices.com)). In addition, our presentation of these measures may not be comparable to similarly titled measures in other companies’ reports. We define Special Items as amounts included in our GAAP financial statements that can vary from period to period and are not reflective of costs incurred in the ordinary course of our operations.

In certain states, we are allowed to withdraw realized trust earnings prior to delivery from cemetery merchandise and services trusts, which management describes as “Withdrawable Trust Income.” The Withdrawable Trust Income, pre-tax, totaled \$0.6 million and \$1.8 million for the years ended December 31, 2015 and 2014, respectively. While the Withdrawable Trust Income is not recognized as revenue in our Consolidated Statements of Operations, it increases cash flow from operations. The Withdrawable Trust Income is treated as a special item in our adjusted net income calculation.

We are providing below a reconciliation of net income from continuing operations (a GAAP measure) to Adjusted net income (a non-GAAP measure). Adjusted net income is defined as net income from continuing operations adjusted for Special Items, including Withdrawable Trust Income, acquisition and divestiture expenses, severance costs and other special items in the table below. The adjustment of Special Items in Adjusted net income allows management to focus on the evaluation of operating performance as it primarily relates to our operating expenses. The Special Items are tax affected at a rate of 34% except for the accretion of the discount on our convertible subordinated notes, which is a non-tax deductible item.

	Year Ended December 31,	
	2014	2015
	(in millions)	
Net income from continuing operations, as reported	\$ 15.4	\$ 20.8
After-tax Special Items, except for items noted by **		
Withdrawable trust income	1.2	0.4
Acquisition and divestiture expenses	0.7	0.4
Severance costs	0.7	0.6
Consulting fees	0.3	1.3
Other incentive compensation	0.7	—
Accretion of discount on convertible subordinated notes **	2.5	3.5
Costs related to the credit facility	0.7	—
Loss on redemption of convertible junior subordinated debentures	2.5	—
Net gain on asset purchase	(0.4)	—
Other special items	0.5	0.2
Tax adjustment from prior period **	—	0.1
Adjusted net income	<u>\$ 24.8</u>	<u>\$ 27.3</u>

The following is a discussion of our results of operations for the years ended December 31, 2015 and 2014. The term “same store” or “existing operations” refers to funeral homes and cemeteries acquired prior to January 1, 2011 and owned and operated for the entirety of each period being presented. Funeral homes and cemeteries purchased after December 31, 2010 are referred to as “acquired.” This classification of acquisitions has been important to management and investors in monitoring the results of these businesses and to gauge the leveraging performance contribution that a selective acquisition program can have on total company performance. Depreciation and amortization and regional and unallocated funeral and cemetery costs are not included in operating profit.



## Results of Operations

*Funeral Home Segment.* The following table sets forth certain information regarding our revenues and operating profit from funeral home continuing operations for the year ended December 31, 2014 compared to the year ended December 31, 2015.

	Year Ended December 31,		Change	
	2014	2015	Amount	Percent
	(dollars in thousands)			
Revenues:				
Same store operating revenue	\$ 127,487	\$ 131,740	\$ 4,253	3.3 %
Acquired operating revenue	36,765	44,628	7,863	21.4 %
Preneed funeral insurance commissions	2,036	1,484	(552)	(27.1)%
Preneed funeral trust earnings	7,447	7,966	519	7.0 %
Revenues from continuing operations	<u>\$ 173,735</u>	<u>\$ 185,818</u>	<u>\$ 12,083</u>	7.0 %
Operating profit:				
Same store operating profit	\$ 46,707	\$ 50,563	\$ 3,856	8.3 %
Acquired operating profit	13,767	17,750	3,983	28.9 %
Preneed funeral insurance commissions	958	454	(504)	(52.6)%
Preneed funeral trust earnings	7,390	7,885	495	6.7 %
Gross profit from continuing operations	<u>\$ 68,822</u>	<u>\$ 76,652</u>	<u>\$ 7,830</u>	11.4 %

Funeral home same store operating revenues for the year ended December 31, 2015 increased \$4.3 million, or 3.3%, when compared to the year ended December 31, 2014. This increase was primarily due to a 2.1% increase in the average revenue per contract to \$5,441 and a slight increase of 0.9% in same store contract volume to 25,270. The average revenue per contract includes the impact of the funeral trust fund earnings recognized at the time that we provide the services pursuant to the preneed contract. Excluding funeral trust earnings, the average revenue per contract increased \$122 to \$5,213 for the year ended December 31, 2015. The average revenue per burial contract increased 2.1% to \$8,681, while the number of traditional burial contracts increased 1.9% to 10,572. The cremation rate for same store businesses increased from 49.3% in 2014 to 50.9% in 2015 as the number of cremation contracts increased 4.3% to 12,868. The average revenue per same store cremation contract increased 5.3% to \$3,217 due to a slight increase in cremations with services which generate higher average revenue per contract than direct cremations. The average revenue for “other” contracts, which are charges for merchandise and services for which we do not perform a funeral service and which make up approximately 7.2% of the total number of contracts in 2015, increased 9.9% to \$2,352.

Same store operating profit for the year ended December 31, 2015 increased \$3.9 million, or 8.3%, from the year ended December 31, 2014. This increase is a result of the increase in revenue coupled with better management of controllable expenses. Those expenses with a significant change include salaries and benefits, bad debt expense and transportation costs which decreased \$0.6 million, offset by an increase of approximately \$0.3 million in in general liability and property tax expense.

Funeral home acquired revenues for the year ended December 31, 2015 increased \$7.9 million, or 21.4%, when compared to the year ended December 31, 2014, as we experienced a 15.6% increase in the number of contracts and an increase in the average revenue per contract of 5.2%, to \$6,240, primarily due to the full year of reporting the acquisition of certain funeral homes from SCI in May 2014 (the “SCI Acquisition”) in 2015 and the acquisition of two funeral home businesses in 2015. Excluding funeral trust earnings, the average revenue per contract increased 5.0% to \$6,066. The number of traditional burial contracts increased 12.0%, and the average revenue per burial contract increased 4.5% to \$8,836. The cremation rate for the acquired businesses increased from 39.7% in 2014 to 42.0% in 2015. The number of cremation contracts increased 22.5% to 3,093 and the average revenue per cremation contract increased 9.5% to \$3,879. The increase in the average revenue per contract for acquired operations is primarily due to an increase of 8.3% in cremations with services which generate higher average revenue per contract than direct cremations.

Acquired operating profit for the year ended December 31, 2015 increased \$4.0 million, or 28.9%, from the year ended December 31, 2014. As a percentage of revenue from acquired businesses, acquired operating profit increased to 39.8% for 2015 from 37.4% for 2014. The increase in operating profit was a result of the increase in acquired revenues from our 2014 and 2015 funeral home acquisitions, including the SCI acquisition and better management of salaries and benefits (the largest controllable expense) as these acquired locations are integrated into our Standards Operating Model. The SCI Acquisition and the acquisition of two funeral home businesses in 2015 accounted for approximately one-third of our total acquired operating revenue and operating profit in the year ended December 31, 2015.

The two categories of financial revenue consist of preneed funeral insurance commission revenue and preneed funeral trust earnings on matured preneed contracts. Preneed funeral insurance commission revenue decreased by approximately \$0.6 million, or 27.1%, for the year ended December 31, 2015 as compared to the same period of 2014. Preneed funeral commission revenue is deferred for one year after the preneed funeral contracts are sold. In 2014, we sold 1,185 fewer preneed funeral contracts than in the same period of the previous year. The majority of the decrease in the number of contracts sold were from insurance vendors for which we receive commission income. Preneed funeral trust earnings increased by approximately \$0.5 million, or 7.0%, in the year ended December 31, 2015 due primarily to trust earnings from our acquired locations. Trust earnings also include trust management fees charged to our wholly-owned registered investment advisor based on the fair market value of the trust assets. Operating profit for the two categories of financial revenue, on a combined basis, decreased 0.3% in 2015 due primarily to the mix and variability of preneed funeral insurance commission revenue and preneed fund funeral trust earnings.

*Cemetery Segment.* The following table sets forth certain information regarding our revenues and operating profit from the cemetery continuing operations for the year ended December 31, 2014 compared to the year ended December 31, 2015:

	Year Ended December 31,		Change	
	2014	2015	Amount	Percent
	(dollars in thousands)			
Revenues:				
Same store operating revenue	\$ 41,257	\$ 43,336	\$ 2,079	5.0%
Acquired operating revenue	1,599	3,321	1,722	107.7%
Cemetery trust earnings	8,123	8,440	317	3.9%
Preneed cemetery finance charges	1,410	1,587	177	12.6%
Revenues from continuing operations	<u>\$ 52,389</u>	<u>\$ 56,684</u>	<u>\$ 4,295</u>	8.2%
Operating Profit:				
Same store operating profit	\$ 11,845	\$ 14,045	\$ 2,200	18.6%
Acquired operating profit	351	1,088	737	210.0%
Cemetery trust earnings	7,931	8,167	236	3.0%
Preneed cemetery finance charges	1,410	1,587	177	12.6%
Gross profit from continuing operations	<u>\$ 21,537</u>	<u>\$ 24,887</u>	<u>\$ 3,350</u>	15.6%

Cemetery same store operating revenues for the year ended December 31, 2015 increased \$2.1 million, or 5.0%, when compared to the year ended December 31, 2014. Preneed property revenue increased \$1.6 million, or 8.2% in the year ended December 31, 2015 as compared to the same period of 2014, as we experienced a 5.0% increase in the number of interment rights (property) sold. The average price per interment increased 5.8% to \$2,988 in 2015 as compared to 2014. The percentage of those interment rights sold that we were able to recognize as revenue, because we received at least 10% of the sales price from the customer, decreased slightly from 91.3% in 2014 to 91.0% in 2015. Revenue from deliveries of preneed merchandise and services increased \$0.1 million, or 2.1%, to \$4.1 million in the year ended December 31, 2015. Same store at-need revenue increased \$0.3 million, or 2.0%, as the number of at-need contracts increased 2.7% to 12,998 in 2015.

Cemetery same store operating profit for the year ended December 31, 2015 increased \$2.2 million, or 18.6%. As a percentage of revenues, cemetery same store operating profit increased from 28.7% in 2014 to 32.4% in 2015. The increase in operating profit was due primarily to the increase in revenue and a \$1.0 million decrease in bad debt expense and transportation costs, offset by an increase of \$0.9 million in salaries and benefits, insurance and grounds maintenance costs.

Cemetery acquired revenue and acquired operating profit increased in 2015 primarily due to the full year reporting of the cemetery acquired from SCI in May 2014.

The two categories of financial revenue consist of trust earnings and finance charges on preneed receivables. Total trust earnings increased 3.9% primarily due to a \$0.4 million increase in merchandise and service trust income, offset by a \$0.1 million decrease in the perpetual care trust income in the year ended December 31, 2015 when compared to 2014. Trust earnings also include trust management fees charged by our wholly-owned registered investment advisor based on the fair market value of the trust assets. Finance charges on the preneed contracts increased 12.6% year over year.

## ***Other Financial Statement Items***

***Regional and Unallocated Funeral and Cemetery Costs.*** Regional and unallocated funeral and cemetery costs consist of salaries and benefits for regional management, field incentive compensation and other related costs for field infrastructure. Regional and unallocated funeral and cemetery costs increased \$2.2 million, or 22.3%, primarily due to an increase of \$1.6 million in incentive compensation for field management and their employees due to better performance and stronger margins from our operations for the year ended December 31, 2015 compared to the same period of 2014. Our Standards Operating Model align our financial incentives for Managing Partners of each business and their teams who consistently achieve a high level of standards. In addition, we experienced an increase of \$0.6 million in salaries and benefits for regional and field management due to additional headcount.

***General and Administrative.*** General and administrative expenses totaled \$27.1 million for the year ended December 31, 2015, a decrease of \$1.8 million, or 6.2%, compared to the year ended December 31, 2014. The decrease was due primarily to a \$1.0 million special one-time bonus payment related to an amended employment agreement and \$0.8 million for stock-based compensation related to the performance awards payout during 2014, both of which did not occur in 2015. Additionally, we had a \$0.6 million decrease in acquisition and divestiture expenses, a \$0.2 million decrease in corporate incentive compensation and a combined decrease of \$0.3 million in legal and public company costs. These decreases were offset by a \$0.6 million increase in non-cash stock compensation expense, a \$0.4 million increase in salaries and benefits and a \$0.1 million increase in regulatory and compliance costs.

***Interest Expense.*** Interest expense was \$10.6 million for the year ended December 31, 2015 compared to \$10.3 million for the year ended December 31, 2014, an increase of \$0.3 million. During the year ended December 31, 2014, we recognized a credit of \$0.6 million in interest expense related to the settled portion of the uncertain tax positions in connection with the completion of an IRS tax audit for our 2011 tax year that did not occur in the year ended December 31, 2015. Additionally, interest expense increased \$0.2 million compared to 2014, related to the acquisition debt associated with the purchase of a funeral home business in February 2015. These were offset by a \$0.4 million decrease related to our Convertible Notes issued in March 2014 which have a lower fixed annual interest rate of 2.75% compared to our redeemed convertible junior subordinated debentures, which had an annual interest rate of 7.0% and a \$0.1 million decrease related to our term loan due to a lower principal balance during the year ended December 31, 2015 as compared to the same period of 2014.

***Accretion of Discount on Convertible Subordinated Notes.*** For the year ended December 31, 2015, we recognized accretion of the discount on our Convertible Notes issued in March 2014 of \$3.5 million. Accretion is calculated using the effective interest method based on a stated interest rate of 6.75%.

***Loss on Early Extinguishment of Debt.*** In April 2014, we entered into a fifth amendment (the “Fifth Amendment”) of our Credit Agreement. As a result, we recognized a loss of approximately \$1.0 million to write-off the related unamortized deferred loan costs. We did not incur this type of expense in 2015.

***Loss on Redemption of Convertible Subordinated Debentures.*** In March 2014, we called for the redemption of all our outstanding convertible junior subordinated debentures due 2029 held by Carriage Services Capital Trust and the corresponding 7% convertible preferred securities (“TIDES”). As of April 16, 2014, all of the TIDES had been redeemed. For the year ended December 31, 2014, we recognized a total loss of \$3.8 million as a result of the write-off of the related unamortized debt issuance costs of \$2.9 million and \$0.9 million for the premium paid on the convertible junior subordinated debentures redeemed. We did not incur this type of expense in 2015.

***Other, net.*** Other Income decreased \$0.6 million for the year ended December 31, 2015 compared to the same period in 2014. During the year ended December 31, 2014, we recognized a net gain of \$0.6 million as a result of a gain of \$1.1 million related to the purchase of a funeral home building previously leased under a capital lease in the first quarter of 2014, offset by a loss of \$0.5 million on the sale of a funeral home building and land in the fourth quarter of 2014.

***Income taxes.*** Our income tax provision was approximately \$13.7 million for the year ended December 31, 2015 compared to \$7.3 million for the year ended December 31, 2014. On August 1, 2014, we received notification that the IRS completed its examination of our tax year ended December 31, 2011. As a result, we re-measured our tax liability for unrecognized tax benefits which resulted in a \$1.7 million tax benefit that reduced our effective tax rate for the year ended December 31, 2014. Excluding this tax benefit, our effective tax rate was 39.6% and 39.7% for the years ended December 31, 2014 and 2015, respectively. See Part II, Item 8, Financial Statements and Supplementary Data, Note 16 for additional information regarding our income taxes.

## LIQUIDITY AND CAPITAL RESOURCES

### Overview

Our primary sources of liquidity and capital resources are internally generated cash flows from operating activities and availability under our Credit Facility.

We generate cash in our operations primarily from at-need sales and delivery of preneed sales. We also generate cash from earnings on our cemetery perpetual care trusts. Based on our recent operating results, current cash position, anticipated future cash flows, we do not anticipate any significant liquidity constraints in the foreseeable future. However, if our capital expenditures or acquisition plans change, we may need to access the capital markets to obtain additional funding. Further, to the extent operating cash flow or access to and cost of financing sources are materially different than expected, future liquidity may be adversely affected. Please read Part I, Item 1A “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2016.

We intend to use cash on hand and borrowings under our Credit Facility primarily to acquire funeral home and cemetery businesses and for internal growth projects, such as cemetery inventory development and funeral home expansion projects. We have the ability to draw on our revolving credit facility, subject to customary terms and conditions of the Credit Agreement. We believe that existing cash balances, future cash flows from operations and borrowings under our Credit Facility described above will be sufficient to meet our anticipated working capital requirements, capital expenditures, scheduled debt payments, commitments, dividends and acquisitions for the foreseeable future.

### Cash Flows

We began 2016 with \$0.5 million in cash and other liquid investments and ended the year with \$3.3 million in cash. At December 31, 2016, we had borrowings of \$67.7 million outstanding on our revolving credit facility.

The following table sets forth the elements of cash flow for the years ended December 31, 2015 and 2016 (in millions):

	2015	2016
Cash at beginning of year	\$ 0.4	\$ 0.5
Cash flow from operating activities	49.9	49.5
Acquisitions and land for new construction	(9.7)	(26.6)
Purchase of land and buildings previously leased	(6.1)	(6.3)
Net proceeds from the sale of business and other assets	0.1	4.4
Growth capital expenditures	(20.0)	(9.4)
Maintenance capital expenditures	(9.7)	(7.4)
Net borrowings on our revolving credit facility, term loan and long-term debt obligations	41.7	1.1
Dividends on common stock	(1.8)	(2.5)
Purchases of treasury stock	(45.0)	—
Payment of loan origination costs related to the credit facility	—	(0.7)
Other financing proceeds	0.7	0.7
Cash at end of year	\$ 0.5	\$ 3.3

For the year ended December 31, 2016, cash provided by operating activities was \$49.5 million, as compared to \$49.9 million for the year ended December 31, 2015, a decrease of \$0.4 million. Favorable changes in our working capital include accrued severance for the retirement of a former executive that has not been fully paid and decreases in our accounts and preneed receivables due to better collections of trade accounts receivable in 2016.

Our investing activities resulted in a net cash outflow of approximately \$45.3 million for the year ended December 31, 2016 compared to a net cash outflow of approximately \$45.5 million for the year ended December 31, 2015, a decrease of \$0.2 million. During the year ended December 31, 2016, we acquired six funeral home businesses, two in Houston, Texas, one in Madera, California, one in Brookfield, Wisconsin, one in Burlington, North Carolina and one in Graham, North Carolina for the aggregate purchase price of approximately \$32.8 million. The purchase price for the businesses consisted of approximately (i) \$23.9 million paid in cash at closing and (ii) \$8.9 million, the net present value of future deferred payments totaling \$13.5 million.

We also purchased land and buildings at four funeral homes that were previously leased for approximately \$6.3 million. In addition, capital expenditures totaled \$16.8 million, of which \$9.4 million and \$7.4 million were growth and maintenance capital expenditures, respectively, for the year ended December 31, 2016. Our growth capital expenditures were primarily related to the construction costs of new funeral home facilities totaling approximately \$3.1 million, renovations at certain business locations of \$2.3 million and cemetery development costs of \$4.0 million. Maintenance capital expenditures for the year ended December 31, 2016 were primarily related to information technology infrastructure improvements of \$0.7 million, vehicle purchases of \$1.5



million, general equipment and furniture purchases of \$2.1 million and maintenance projects such as paving roads, parking lots, facility repairs and improvements of \$3.1 million.

During the year ended December 31, 2015, we acquired two funeral home businesses for approximately \$15.0 million. The purchase price for both businesses consisted of approximately (i) \$9.7 million paid in cash at closing, (ii) \$4.5 million, the net present value of future deferred payments totaling \$5.5 million and (iii) \$0.8 million, the net present value of contingent consideration totaling \$1.0 million.

We also purchased the land and buildings at three funeral home locations that were previously leased for approximately \$6.1 million. In addition, capital expenditures totaled \$29.7 million, of which \$20.0 million and \$9.7 million were growth and maintenance capital expenditures, respectively, for the year ended December 31, 2015. Our growth capital expenditures were primarily related to the construction costs of three new funeral home facilities totaling approximately \$12.7 million, renovations at certain business locations of \$4.2 million and cemetery development costs of \$3.0 million. Maintenance capital expenditures for the year ended December 31, 2015 were primarily related to corporate payroll systems improvements of approximately \$1.1 million, information technology infrastructure improvements of \$1.3 million, vehicle purchased of \$2.1 million, general equipment and furniture purchases of \$2.1 million and maintenance projects such as paving roads, parking lots, facility repairs and improvements of \$3.1 million.

Our financing activities resulted in a net cash outflow of \$1.4 million for the year ended December 31, 2016 compared to a net cash outflow of \$4.3 million for the year ended December 31, 2015. For the year ended December 31, 2016, we had net borrowings on our revolving credit facility and term loan of approximately \$1.1 million compared to approximately \$41.7 million during the year ended December 31, 2015. We paid approximately \$2.5 million in dividends on our common stock for the year ended December 31, 2016 compared to dividends of \$1.8 million for the year ended December 31, 2015. We purchased treasury stock for \$45.0 million during the year ended December 31, 2015.

#### *Dividends*

Our Board declared two quarterly dividends of \$0.025 per share and two quarterly dividends of \$0.05 per share, totaling approximately \$2.5 million. The two dividends of \$0.025 per share were paid on March 1, 2016 and June 1, 2016 and the two dividends of \$0.05 per share were paid on September 1, 2016 and December 1, 2016. During 2015, we paid four quarterly dividends of \$0.025 per share, totaling approximately \$1.8 million.

#### *Share Repurchase*

On February 25, 2016, our Board approved a share repurchase program authorizing us to purchase up to an aggregate of \$25.0 million of our common stock in accordance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended. The shares may be purchased from time to time in the open market or in privately negotiated transactions. Purchases will be at times and in amounts as management deems appropriate based on factors such as market conditions, legal requirements and other business considerations. During the year ended December 31, 2016, we did not repurchase any shares of common stock pursuant to this share repurchase program.

During 2015, we purchased 1,927,665 shares of our common stock for a total cost of \$45.0 million, at an average cost of \$23.34 per share under a previous share repurchase program.

#### *Debt Obligations*

The outstanding principal balance of our long-term debt and capital lease obligations totaled \$221.6 million at December 31, 2016 and consisted of \$138.8 million under our term loan, \$67.7 million outstanding under our revolving credit facility and \$15.1 million in acquisition indebtedness and capital lease obligations. We have one letter of credit issued and outstanding under the Credit Facility at December 31, 2016. The letter of credit was issued on November 30, 2016 for approximately \$2.0 million, bears interest at 2.125% and will expire on November 27, 2017.

At December 31, 2016, we had a \$300 million secured bank credit facility with Bank of America, N.A. as Administrative Agent comprised of a \$150 million revolving credit facility and a \$150 million term loan. The Credit Facility contains an accordion provision to borrow up to an additional \$75 million in revolving loans, subject to certain conditions. The Credit Facility matures on February 9, 2021 and is collateralized by all personal property and funeral home real property in certain states. Under the Credit Agreement, outstanding borrowings bear interest at either a prime rate or a LIBOR rate, plus an applicable margin based upon the Company's leverage ratio. As of December 31, 2016, the prime rate margin was equivalent to 1.125% and the LIBOR margin was 2.125%. The weighted average interest rate on the Credit Facility for the year ended December 31, 2016 was 2.8%.

On February 9, 2016, we entered into a seventh amendment (the "Seventh Amendment") to our Credit Facility. The Seventh Amendment resulted in, among other things, (i) reducing our LIBOR based variable interest rate 37.5 basis points, (ii) extending the maturity so that the Credit Agreement will mature at the earlier of (a) any date that is 91 days prior to the maturity of any

subordinated debt (including the \$143.75 million in principal amount of the Convertible Notes, as defined in Note 14 to the Consolidated Financial Statements included herein) or (b) February 9, 2021, (iii) increasing and funding the term loan so that \$150 million was outstanding upon the effectiveness of the Seventh Amendment, (iv) reducing the size of the revolver to \$150 million, (v) increasing the accordion to \$75 million and (vi) updating the amortization payments for the term loan facility so that the borrowings under the term loan facility are subject to amortization payments of (a) \$2.81 million at the end of each fiscal quarter beginning with the fiscal quarter ending March 31, 2016 through the fiscal quarter ending December 31, 2017, (b) \$3.75 million at the end of each fiscal quarter beginning with the fiscal quarter ending March 31, 2018 through the fiscal quarter ending March 31, 2020 and (c) \$4.69 million at the end of each fiscal quarter beginning with the fiscal quarter ending June 30, 2020 through the fiscal quarter ending December 31, 2020. In connection with the Seventh Amendment, we recognized a loss of \$0.6 million to write-off the related unamortized debt issuance costs.

We have no material assets or operations independent of our subsidiaries. All assets and operations are held and conducted by subsidiaries, each of which have fully and unconditionally guaranteed our obligations under the Credit Agreement. Additionally, we do not currently have any significant restrictions on our ability to receive dividends or loans from any subsidiary guarantor under the Credit Agreement.

We were in compliance with the covenants contained in our Credit Agreement as of December 31, 2015 and 2016. The Credit Agreement calls for key ratios that we must comply with including a requirement to maintain a leverage ratio of no more than 3.50 to 1.00 and a covenant to maintain a fixed charge coverage ratio of no less than 1.20 to 1.00. As of December 31, 2016, the leverage ratio was 2.92 to 1.00 and the fixed charge coverage ratio was 2.21 to 1.00.

#### *Convertible Subordinated Notes due 2021*

The Convertible Notes have not been registered under the Securities Act, and were offered only to “qualified institutional buyers” in compliance with Rule 144A under the Securities Act. The Convertible Notes are governed by an indenture dated as of March 19, 2014 between Wilmington Trust, National Association, as Trustee, and us (the “Indenture”). The Convertible Notes are general unsecured obligations and will be subordinated in the right of payment to all of our existing and future senior indebtedness and equal in right of payment with our other existing and future subordinated indebtedness. The Convertible Notes bear interest at 2.75% per year. Interest on the Convertible Notes began to accrue on March 19, 2014 and is payable semi-annually in arrears on March 15 and September 15 of each year.

The initial conversion rate of the Convertible Notes was 44.3169 shares of our common stock per \$1,000 principal amount of the Convertible Notes, equivalent to an initial conversion price of approximately \$22.56 per share of common stock. The conversion rate is subject to adjustment upon the occurrence of certain events, as described in the Indenture. During the year ended December 31, 2016, an adjustment to the conversion rate of the Convertible Notes was triggered when our Board increased the dividends declared per common share from \$0.025 per share to \$0.05 per share. At December 31, 2016, the adjusted conversion rate of the Convertible Notes is 44.4108 shares of our common stock per \$1,000 principal amount of Convertible Notes, equivalent to an adjusted conversion price of approximately \$22.52 per share of common stock.

The Convertible Notes mature on March 15, 2021, unless earlier converted or purchased by us. The conversion option of the Convertible Notes is not an embedded derivative. Holders of the Convertible Notes may convert their Convertible Notes at their option at any time prior to December 15, 2020, if certain conditions are met. We may not redeem the Convertible Notes prior to maturity. However, in the event of a fundamental change (as defined in the Indenture), subject to certain conditions, a holder of the Convertible Notes will have the option to require us to purchase all or a portion of its Convertible Notes for cash. The fundamental change purchase price will equal 100% of the principal amount of the Convertible Notes to be purchased, plus any accrued and unpaid interest up to, but excluding, the fundamental change purchase date.

At December 31, 2016, the carrying amount of the equity component was approximately \$18.0 million. At December 31, 2016, the principal amount of the liability component was \$143.75 million and the net carrying amount was \$121.9 million. The unamortized discount of \$21.9 million as of December 31, 2016 is being amortized over the remaining term of approximately 50 months.

Interest expense on the Convertible Notes included contractual coupon interest expense of \$4.0 million for both the years ended December 31, 2015 and 2016. Accretion of the discount on the Convertible Notes was approximately \$3.5 million and \$3.9 million for the years ended December 31, 2015 and 2016, respectively. Amortization of debt issuance costs related to our Convertible Notes was approximately \$0.5 million for both the years ended December 31, 2015 and 2016. The effective interest rate on the unamortized discount and the debt issuance costs for the years ended December 31, 2015 and 2016 was 6.75% and 2.75%, respectively.



## CONTRACTUAL OBLIGATIONS

The following table summarizes the known future payments required for the debt on our Consolidated Balance Sheet as of December 31, 2016. Where appropriate we have indicated the footnote in Part II, Item 8, Financial Statements and Supplementary Data, Notes to Consolidated Financial Statements where additional information is available.

	Financial Note Reference	Payments Due By Period (in millions)						
		Total	2017	2018	2019	2020	2021	After 5 Years
Long-term debt obligations	13	\$ 218.7	\$ 13.0	\$ 16.9	\$ 16.9	\$ 19.0	\$ 148.4	\$ 4.5
Interest obligation on long-term debt <sup>(a)</sup>		27.2	6.8	6.4	5.7	5.1	1.2	2.0
Capital lease obligations, including interest	15	4.9	0.5	0.4	0.4	0.3	0.3	3.0
Convertible subordinated notes <sup>(b)</sup>	14	143.8	—	—	—	—	143.8	—
Interest on convertible subordinated notes	14	16.6	3.9	3.9	3.9	3.9	1.0	—
Operating lease obligations	15	13.1	4.2	2.7	2.4	1.8	1.4	0.6
Total contractual obligations		<u>\$ 424.3</u>	<u>\$ 28.4</u>	<u>\$ 30.3</u>	<u>\$ 29.3</u>	<u>\$ 30.1</u>	<u>\$ 296.1</u>	<u>\$ 10.1</u>

(a) Based on interest rates in effect at December 31, 2016.

(b) Matures in 2021.

## OFF-BALANCE SHEET ARRANGEMENTS

The following table summarizes our off-balance sheet arrangements as of December 31, 2016. Where appropriate, we have indicated the footnote in Part II, Item 8, Financial Statements and Supplementary Data, Notes to the Consolidated Financial Statements where additional information is available. We have various non-compete agreements with former owners and employees of businesses we have acquired. These agreements are generally for one to ten years and provide for periodic payments over the term of the agreements. We have various consulting agreements with former owners of businesses we have acquired. Payments for such agreements are generally not made in advance. These agreements are generally for one to ten years and provide for bi-weekly or monthly payments. We have employment agreements with certain of our executive officers and senior leadership. These agreements are generally for three to four years and provide for participation in various incentive compensation arrangements. These agreements automatically renew on an annual basis after their initial term has expired.

	Financial Note Reference	Payments Due By Period (in millions)						
		Total	2017	2018	2019	2020	2021	After 5 Years
Non-compete agreements	15	\$ 8.1	\$ 2.4	\$ 1.3	\$ 1.1	\$ 0.9	\$ 0.8	\$ 1.6
Consulting agreements	15	3.2	1.5	0.7	0.5	0.3	0.2	—
Employment agreements	15	1.8	1.7	0.1	—	—	—	—
Total contractual cash obligations		<u>\$ 13.1</u>	<u>\$ 5.6</u>	<u>\$ 2.1</u>	<u>\$ 1.6</u>	<u>\$ 1.2</u>	<u>\$ 1.0</u>	<u>\$ 1.6</u>

The obligations related to our off-balance sheet arrangements are significant to our future liquidity; however, although we can provide no assurances, we anticipate that these obligations will be funded from cash provided from our operating activities. If we are not able to meet these obligations with cash provided by our operating activities, we may be required to access the capital markets or draw down on our revolving credit facility, both of which may be more difficult to access.

## SEASONALITY

Our business can be affected by seasonal fluctuations in the death rate. Generally, the number of deaths is higher during the winter months because the incidences of death from influenza and pneumonia are higher during this period than other periods of the year.

## INFLATION

Inflation has not had a material impact on our results of operations over the last three fiscal years.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

In the ordinary course of business, we are typically exposed to a variety of market risks. Currently, these are primarily related to interest rate risk and changes in the values of securities associated with the preneed and perpetual care trusts. Management is actively involved in monitoring exposure to market risk and developing and utilizing appropriate risk management techniques when appropriate and when available for a reasonable price. We are not exposed to any other significant market risks.

The following quantitative and qualitative information is provided about financial instruments to which we are a party at December 31, 2016, and from which we may incur future gains or losses from changes in market conditions. We do not enter into derivative or other financial instruments for speculative or trading purposes.

Hypothetical changes in interest rates and the values of securities associated with the preneed and perpetual care trusts chosen for the following estimated sensitivity analysis are considered to be reasonable near-term changes generally based on consideration of past fluctuations for each risk category. However, since it is not possible to accurately predict future changes in interest rates, these hypothetical changes may not necessarily be an indicator of probable future fluctuations.

The following information about our market-sensitive financial instruments constitutes a “forward-looking statement.”

In connection with our preneed funeral operations and preneed cemetery merchandise and service sales, the related funeral and cemetery trust funds own investments in equity and debt securities and mutual funds, which are sensitive to current market prices. Cost and market values of such investments as of December 31, 2016 are presented in Part II, Item 8, Financial Statements and Supplementary Data, Notes 6, 8 and 10. The sensitivity of the fixed income securities is such that a 0.25% change in interest rates causes an approximate 1.49% change in the value of the fixed income securities.

We monitor current and forecasted interest rate risk in the ordinary course of business and seek to maintain optimal financial flexibility, quality and solvency. As of December 31, 2016, we had \$67.7 million outstanding under our \$150.0 million revolving credit facility and \$138.8 million outstanding on our term loan. Any further borrowings or voluntary prepayments against the revolving credit facility or any change in the floating rate would cause a change in interest expense. We have the option to pay interest under our Credit Facility at either the prime rate or the LIBOR rate plus a margin. At December 31, 2016, the prime rate margin was equivalent to 1.125% and the LIBOR margin was 2.125%. Assuming the outstanding balance remains unchanged, a change of 100 basis points in our borrowing rate would result in a change in income before taxes of \$2.1 million. We have not entered into interest rate hedging arrangements in the past. Management continually evaluates the cost and potential benefits of interest rate hedging arrangements.

Our Convertible Notes pay interest at the fixed annual rate of 2.75% and are carried on our Consolidated Balance Sheets at a cost of approximately \$121.9 million. The fair value of the Convertible Notes was approximately \$194.6 million at December 31, 2016 based on the last traded or broker quoted price, as reported by the Financial Industry Regulatory Authority, Inc. Increases in market interest rates may cause the value of the Convertible Notes to decrease, but such changes will not affect our interest costs.

The remainder of our long-term debt and leases consist of non-interest bearing notes and fixed rate instruments that do not trade in a market and do not have a quoted market value. Any increase in market interest rates causes the fair value of those liabilities to decrease, but such changes will not affect our interest costs.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.**

**CARRIAGE SERVICES, INC.  
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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## Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders  
Carriage Services, Inc.:

We have audited the accompanying consolidated balance sheets of Carriage Services, Inc. (a Delaware corporation) and subsidiaries (the “Company”) as of December 31, 2015 and 2016, and the related consolidated statements of operations, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2016. Our audits of the basic consolidated financial statements included the financial statement schedule listed in the index appearing under Item 15(2). These financial statements and financial statement schedule are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Carriage Services, Inc. and subsidiaries as of December 31, 2015 and 2016, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2016 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, the Company adopted new accounting guidance in 2016, related to the presentation of deferred income taxes and debt issuance costs.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of December 31, 2016, based on criteria established in the 2013 *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated February 23, 2017 expressed an unqualified opinion.

/s/ GRANT THORNTON LLP

Houston, Texas  
February 23, 2017

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Carriage Services, Inc.:

We have audited the internal control over financial reporting of Carriage Services, Inc. (a Delaware corporation) and subsidiaries (the “Company”) as of December 31, 2016, based on criteria established in the 2013 *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in the 2013 *Internal Control-Integrated Framework* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of the Company as of and for the year ended December 31, 2016, and our report dated February 23, 2017 expressed an unqualified opinion on those financial statements.

/s/ GRANT THORNTON LLP

Houston, Texas  
February 23, 2017

**CARRIAGE SERVICES, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)

	December 31,	
	2015	2016
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 535	\$ 3,286
Accounts receivable, net of allowance for bad debts of \$1,054 in 2015 and \$1,071 in 2016	18,181	18,860
Inventories	5,654	6,147
Prepaid expenses	4,684	2,640
Other current assets	4,707	2,034
Total current assets	33,761	32,967
Preneed cemetery trust investments	63,291	69,696
Preneed funeral trust investments	85,553	89,240
Preneed receivables, net of allowance for bad debts of \$2,042 in 2015 and \$2,166 in 2016	27,998	30,383
Receivables from preneed trusts	13,544	14,218
Property, plant and equipment, net of accumulated depreciation of \$103,306 in 2015 and \$110,509 in 2016	214,874	235,113
Cemetery property, net of accumulated amortization of \$30,289 in 2015 and \$34,194 in 2016	75,597	76,119
Goodwill	264,416	275,487
Intangible and other non-current assets	10,978	14,957
Cemetery perpetual care trust investments	43,127	46,889
Total assets	<u>\$ 833,139</u>	<u>\$ 885,069</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	\$ 12,236	\$ 13,267
Accounts payable	7,917	10,198
Other liabilities	524	717
Accrued liabilities	16,541	20,091
Total current liabilities	37,218	44,273
Long-term debt, net of current portion	103,495	137,862
Revolving credit facility	91,514	66,542
Convertible subordinated notes due 2021	115,227	119,596
Obligations under capital leases, net of current portion	2,875	2,630
Deferred preneed cemetery revenue	56,721	54,631
Deferred preneed funeral revenue	31,748	33,198
Deferred tax liability	39,956	40,555
Other long-term liabilities	5,531	2,567
Deferred preneed cemetery receipts held in trust	63,291	69,696
Deferred preneed funeral receipts held in trust	85,553	89,240
Care trusts' corpus	42,416	46,290
Total liabilities	675,545	707,080
Commitments and contingencies:		
Stockholders' equity:		
Common stock, \$.01 par value; 80,000,000 shares authorized; 22,497,873 and 22,490,855 issued as of December 31, 2015 and 2016, respectively	225	225
Additional paid-in capital	214,250	215,064
Retained earnings	3,385	22,966
Treasury stock, at cost; 5,849,316 shares at December 31, 2015 and 2016, respectively	(60,266)	(60,266)
Total stockholders' equity	157,594	177,989
Total liabilities and stockholders' equity	<u>\$ 833,139</u>	<u>\$ 885,069</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.



**CARRIAGE SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data)

	Year Ended December 31,		
	2014	2015	2016
Revenues:			
Funeral	\$ 173,735	\$ 185,818	\$ 189,401
Cemetery	52,389	56,684	58,799
	<u>226,124</u>	<u>242,502</u>	<u>248,200</u>
Field costs and expenses:			
Funeral	104,913	109,166	110,218
Cemetery	30,852	31,797	33,569
Depreciation and amortization	10,545	12,034	13,919
Regional and unallocated funeral and cemetery costs	9,806	11,997	10,844
	<u>156,116</u>	<u>164,994</u>	<u>168,550</u>
Gross profit	<u>70,008</u>	<u>77,508</u>	<u>79,650</u>
Corporate costs and expenses:			
General, administrative and other	28,915	27,114	27,944
Home office depreciation and amortization	1,378	1,746	1,502
	<u>30,293</u>	<u>28,860</u>	<u>29,446</u>
Operating income	<u>39,715</u>	<u>48,648</u>	<u>50,204</u>
Interest expense	(10,308)	(10,559)	(11,738)
Accretion of discount on convertible subordinated notes	(2,452)	(3,454)	(3,870)
Loss on early extinguishment of debt	(1,042)	—	(567)
Loss on redemption of convertible junior subordinated debentures	(3,779)	—	—
Other, net	567	(45)	(1,788)
Total interest and other, net	<u>(17,014)</u>	<u>(14,058)</u>	<u>(17,963)</u>
Income from continuing operations before income taxes	<u>22,701</u>	<u>34,590</u>	<u>32,241</u>
Provision for income taxes	(8,995)	(13,737)	(12,682)
Income tax benefit related to certain discrete items	1,740	—	22
Net provision for income taxes	<u>(7,255)</u>	<u>(13,737)</u>	<u>(12,660)</u>
Net income from continuing operations	<u>15,446</u>	<u>20,853</u>	<u>19,581</u>
Income from discontinued operations, net of tax	392	—	—
Net income	<u>\$ 15,838</u>	<u>\$ 20,853</u>	<u>\$ 19,581</u>
Basic earnings per common share:			
Continuing operations	\$ 0.84	\$ 1.16	\$ 1.18
Discontinued operations	0.02	—	—
Basic earnings per common share	<u>\$ 0.86</u>	<u>\$ 1.16</u>	<u>\$ 1.18</u>
Diluted earnings per common share:			
Continuing operations	\$ 0.83	\$ 1.12	\$ 1.12
Discontinued operations	0.02	—	—
Diluted earnings per common share	<u>\$ 0.85</u>	<u>\$ 1.12</u>	<u>\$ 1.12</u>
Dividends declared per share	<u>\$ 0.10</u>	<u>\$ 0.10</u>	<u>\$ 0.15</u>
Weighted average number of common and common equivalent shares outstanding:			
Basic	18,108	17,791	16,515
Diluted	<u>18,257</u>	<u>18,313</u>	<u>17,460</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

**CARRIAGE SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
(in thousands)

	Shares Outstanding	Common Stock	Additional Paid-in Capital	Retained Earnings (Deficit)	Treasury Stock	Total
<b>Balance – December 31, 2013</b>	18,261	\$ 222	\$ 204,324	\$ (33,306)	\$ (15,267)	\$ 155,973
Net Income – 2014	—	—	—	15,838	—	15,838
Issuance of common stock	70	—	1,110	—	—	1,110
Exercise of stock options	68	—	363	—	—	363
Issuance of restricted common stock	200	2	(2)	—	—	—
Cancellation and retirement of restricted common stock and stock options	(87)	—	(1,357)	—	—	(1,357)
Accelerated vesting of restricted common stock and options	—	—	27	—	—	27
Stock-based compensation expense	—	—	4,422	—	—	4,422
Dividends on common stock	—	—	(1,840)	—	—	(1,840)
Performance-based stock award payments	—	—	(16,624)	—	—	(16,624)
Convertible subordinated notes due 2021	—	—	17,973	—	—	17,973
Excess tax benefit on equity compensation	—	—	3,990	—	—	3,990
<b>Balance – December 31, 2014</b>	18,512	\$ 224	\$ 212,386	\$ (17,468)	\$ (15,267)	\$ 179,875
Net Income – 2015	—	—	—	20,853	—	20,853
Issuance of common stock	53	1	981	—	—	982
Exercise of stock options	43	—	—	—	—	—
Issuance of restricted common stock	43	1	50	—	—	51
Cancellation and retirement of restricted common stock and stock options	(75)	(1)	(1,607)	—	—	(1,608)
Stock-based compensation expense	—	—	4,195	—	—	4,195
Dividends on common stock	—	—	(1,819)	—	—	(1,819)
Treasury stock acquired	(1,928)	—	—	—	(44,999)	(44,999)
Excess tax benefit on equity compensation	—	—	64	—	—	64
<b>Balance – December 31, 2015</b>	16,648	\$ 225	\$ 214,250	\$ 3,385	\$ (60,266)	\$ 157,594
Net Income – 2016	—	—	—	19,581	—	19,581
Issuance of common stock	45	—	872	—	—	872
Exercise of stock options	48	1	—	—	—	1
Issuance of restricted common stock	18	—	12	—	—	12
Cancellation and retirement of restricted common stock and stock options	(118)	(1)	(888)	—	—	(889)
Stock-based compensation expense	—	—	3,526	—	—	3,526
Dividends on common stock	—	—	(2,492)	—	—	(2,492)
Excess tax deficit on equity compensation	—	—	(216)	—	—	(216)
<b>Balance – December 31, 2016</b>	16,641	\$ 225	\$ 215,064	\$ 22,966	\$ (60,266)	\$ 177,989

The accompanying notes are an integral part of these Consolidated Financial Statements.

**CARRIAGE SERVICES, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	For the Years Ended December 31,		
	2014	2015	2016
Cash flows from operating activities:			
Net income	\$ 15,838	\$ 20,853	\$ 19,581
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	11,945	13,780	15,421
Provision for losses on accounts receivable	2,877	1,679	2,098
Stock-based compensation expense	4,622	4,444	3,229
Deferred income tax expense	5,295	3,035	4,855
Amortization of deferred financing costs	908	921	824
Accretion of discount on convertible subordinated notes	2,452	3,454	3,870
Loss on early extinguishment of debt	1,042	—	567
Loss on redemption of convertible junior subordinated debentures	2,932	—	—
Net (gain) loss on sale of businesses and disposal of other assets	(2,150)	(49)	2,077
Impairment of intangibles	1,180	—	145
Changes in operating assets and liabilities that provided (required) cash:			
Accounts and preneed receivables	(4,146)	(2,310)	(5,162)
Inventories and other current assets	(2,590)	2,582	1,995
Intangible and other non-current assets	(165)	150	(1,155)
Preneed funeral and cemetery trust investments	(203)	25,543	(14,528)
Accounts payable	(562)	1,445	2,112
Accrued and other liabilities	(1,529)	509	202
Deferred preneed funeral and cemetery revenue	303	329	(640)
Deferred preneed funeral and cemetery receipts held in trust	(1,484)	(26,461)	13,966
Net cash provided by operating activities	36,565	49,904	49,457
Cash flows from investing activities:			
Acquisitions and land for new construction	(57,874)	(9,725)	(26,556)
Purchase of land and buildings previously leased	(7,600)	(6,080)	(6,258)
Net proceeds from sale of businesses and other assets	2,192	65	4,385
Capital expenditures	(16,075)	(29,744)	(16,846)
Net cash used in investing activities	(79,357)	(45,484)	(45,275)
Cash flows from financing activities:			
Borrowings from the revolving credit facility	144,600	103,600	71,200
Payments against the revolving credit facility	(141,000)	(51,500)	(96,100)
Borrowings from the term loan	15,875	1,562	39,063
Payments against the term loan	(12,562)	(10,937)	(11,250)
Payments on long-term debt and obligations under capital leases	(840)	(1,014)	(1,789)
Proceeds from the exercise of stock options and employee stock purchase plan contributions	1,228	758	870
Dividends on common stock	(1,840)	(1,819)	(2,492)
Payment of loan origination costs	(825)	(13)	(717)
Proceeds from the issuance of convertible subordinated notes	143,750	—	—
Payment of debt issuance costs related to the convertible subordinated notes	(4,650)	—	—
Redemption of convertible junior subordinated debentures	(89,748)	—	—
Payments for performance-based stock awards	(16,150)	—	—
Purchase of treasury stock	—	(44,999)	—
Excess tax benefit (deficiency) of equity compensation	3,990	64	(216)
Net cash provided by (used in) financing activities	41,828	(4,298)	(1,431)
Net (decrease) increase in cash and cash equivalents	(964)	122	2,751
Cash and cash equivalents at beginning of year	1,377	413	535
Cash and cash equivalents at end of year	\$ 413	\$ 535	\$ 3,286

The accompanying notes are an integral part of these Consolidated Financial Statements.

### 1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### *The Company*

Carriage Services, Inc. (“Carriage,” the “Company,” “we,” “us,” or “our”) is a leading provider of funeral and cemetery services and merchandise in the United States. At December 31, 2016, we operated 170 funeral homes in 28 states and 32 cemeteries in 11 states.

Our operations are reported in two business segments: Funeral Home Operations and Cemetery Operations. Funeral homes are principally service businesses that provide funeral services (traditional burial and cremation) and sell related merchandise, such as caskets and urns. Cemeteries are primarily a sales business providing interment rights (grave sites and mausoleums) and related merchandise, such as markers and memorials.

#### *Principles of Consolidation*

The accompanying Consolidated Financial Statements include the Company and its subsidiaries. All significant intercompany balances and transactions have been eliminated.

#### *Reclassifications*

Certain reclassifications have been made to prior period amounts to conform to the current period financial statement presentation with no effect on our previously reported results of operations, consolidated financial position, or cash flows.

#### *Use of Estimates*

The preparation of our Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our estimates and judgments, including those related to revenue recognition, realization of accounts receivable, goodwill, intangible assets, property and equipment and deferred tax assets and liabilities. We base our estimates on historical experience, third party data and assumptions that we believe to be reasonable under the circumstances. The results of these considerations form the basis for making judgments about the amount and timing of revenues and expenses, the carrying value of assets and the recorded amounts of liabilities. Actual results may differ from these estimates and such estimates may change if the underlying conditions or assumptions change. Historical performance should not be viewed as indicative of future performance, as there can be no assurance that our results of operations will be consistent from year to year.

#### *Cash and Cash Equivalents*

We consider all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents.

#### *Inventory*

Inventory consists primarily of caskets, outer burial containers and cemetery monuments and markers and is recorded at the lower of its cost basis (determined by the specific identification method) or net realizable value.

#### *Funeral and Cemetery Operations*

We record the revenue from sales of funeral and cemetery merchandise and services when the merchandise is delivered or the service is performed. Sales of cemetery interment rights are recorded as revenue in accordance with the retail land sales provisions for accounting for sales of real estate. This method provides for the recognition of revenue in the period in which the customer’s cumulative payments exceed 10% of the contract price related to the interment right. Costs related to the sales of interment rights, which include real property and other costs related to cemetery development activities, are charged to operations using the specific identification method in the period in which the sale of the interment right is recognized as revenue. We recorded amortization expense for cemetery property of approximately \$2.8 million, \$3.4 million and \$3.9 million for 2014, 2015 and 2016, respectively. Sales taxes collected are recognized on a net basis in our Consolidated Financial Statements.

Allowances for bad debts and customer cancellations are provided at the date that the sale is recognized as revenue and are based on our historical experience and the current economic environment. We also monitor changes in delinquency rates and provide additional bad debt and cancellation reserves when warranted.

When preneed sales of funeral services and merchandise are funded through third-party insurance policies, we earn a commission on the sale of the policies. Insurance commissions are recognized as revenues at the point at which the commission

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

is no longer subject to refund, which is typically one year after the policy is issued. Preneed selling costs consist of sales commissions that we pay our sales counselors and other direct related costs of originating preneed sales contracts. These costs are expensed as incurred.

Accounts receivable included approximately \$8.2 million and \$8.7 million of funeral receivables at December 31, 2015 and 2016, respectively, and \$9.7 million and \$9.9 million of cemetery receivables at December 31, 2015 and 2016, respectively. For 2015 and 2016, accounts receivable also include minor amounts of other receivables. Non-current preneed receivables represent the payments expected to be received beyond one year from the balance sheet date. Non-current preneed receivables consisted of approximately \$7.3 million and \$7.8 million of funeral receivables and \$20.7 million and \$22.6 million of cemetery receivables at December 31, 2015 and 2016, respectively. Bad debt expense totaled approximately \$2.9 million, \$1.7 million and \$2.1 million for 2014, 2015 and 2016, respectively.

### *Preneed Contracts*

We sell interment rights, merchandise and services prior to the time of need, which is referred to as preneed. In many instances the customer pays for the preneed contract over a period of time. Cash proceeds from preneed sales less amounts that we may retain under state regulations are deposited to a trust or used to purchase a third-party insurance policy. The principal and accumulated earnings of the trusts are generally withdrawn at maturity (death) or cancellation. The cumulative trust income earned and the increases in insurance benefits on the insurance products are deferred until the service is performed. The customer receivables and amounts deposited in trusts that we control are primarily included in the non-current asset section of our Consolidated Balance Sheets. The preneed funeral contracts secured by third party insurance policies are not recorded as assets or liabilities of the Company. See Note 9 to the Consolidated Financial Statements herein for further information regarding estimated revenues associated with preneed funeral contracts secured by third party insurance policies.

In the opinion of management, the proceeds from the trust funds and the insurance policies at the time the preneed contracts mature will exceed the estimated future costs to perform services and provide products under such arrangements. The types of securities in which the trusts may invest are regulated by state agencies.

### *Preneed Funeral and Cemetery Trust Funds*

Our preneed and perpetual care trust funds are reported in accordance with the principles of consolidating Variable Interest Entities ("VIE's"). In the case of preneed trusts, the customers are the legal beneficiaries. In the case of perpetual care trusts, we do not have a right to access the corpus in the perpetual care trusts. We have recognized financial interests of third parties in the trust funds in our financial statements as *Deferred preneed funeral and cemetery receipts held in trust* and *Care trusts' corpus*. The investments of such trust funds are classified as available-for-sale and are reported at fair market value; therefore, the unrealized gains and losses, as well as accumulated and undistributed income and realized gains and losses are recorded to *Deferred preneed funeral and cemetery receipts held in trust* and *Care trusts' corpus* on our Consolidated Balance Sheets. Our future obligations to deliver merchandise and services are reported at estimated settlement amounts. Preneed funeral and cemetery trust investments are reduced by the trust investment earnings that we have been allowed to withdraw in certain states prior to maturity. These earnings, along with preneed contract collections not required to be placed in trust, are recorded in *Deferred preneed funeral revenue* and *Deferred preneed cemetery revenue* until the service is performed or the merchandise is delivered.

In accordance with respective state laws, we are required to deposit a specified amount into perpetual and memorial care trust funds for each interment/entombment right and certain memorials sold. Income from the trust funds is distributed to us and used to provide for the care and maintenance of the cemeteries and mausoleums. Such trust fund income is recognized as revenue when realized by the trust and distributable to us. We are restricted from withdrawing any of the principal balances of these funds.

An enterprise is required to perform an analysis to determine whether the enterprise's variable interest(s) give it a controlling financial interest in a VIE. This analysis identifies the primary beneficiary of a VIE as the enterprise that has both the power to direct the activities of the VIE that most significantly impact the entity's economic performance and the obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE. Our analysis continues to support our position as the primary beneficiary in the majority of our funeral and cemetery trust funds.

Trust management fees are earned by us for investment management and advisory services that are provided by our wholly-owned registered investment advisor ("CSV RIA"). As of December 31, 2016, CSV RIA provided these services to two institutions, which have custody of 79% of our trust assets, for a fee based on the market value of trust assets. Under state trust laws, we are allowed to charge the trust a fee for advising on the investment of the trust assets and these fees are recognized as income in the period in which services are provided.

We determine whether or not the assets in the preneed trusts have an other-than-temporary impairment on a security-by-security basis. This assessment is made based upon a number of criteria including the length of time a security has been in a loss position, changes in market conditions and concerns related to the specific issuer. If a loss is considered to be other-than-temporary,

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

the cost basis of the security is adjusted downward to its fair market value. Any reduction in the cost basis of the investment due to an other-than-temporary impairment is likewise recorded as a reduction to *Deferred preneed funeral and cemetery receipts held in trust* and *Care trusts' corpus* on our Consolidated Balance Sheets. There will be no impact on earnings unless and until such time that the investment is withdrawn from the trust in accordance with state regulations at an amount that is less than its original basis.

### *Property, Plant and Equipment*

Property, plant and equipment (including equipment under capital leases) are stated at cost. The costs of ordinary maintenance and repairs are charged to operations as incurred, while renewals and betterments are capitalized. Depreciation of property, plant and equipment (including equipment under capital leases) is computed based on the straight-line method over the following estimated useful lives of the assets:

	Years
Buildings and improvements	15 to 40
Furniture and fixtures	5 to 10
Machinery and equipment	3 to 15
Automobiles	5 to 7

Property, plant and equipment was comprised of the following at December 31, 2015 and 2016:

	December 31, 2015	December 31, 2016
	(in thousands)	
Land	\$ 65,433	\$ 73,744
Buildings and improvements	180,804	195,214
Furniture, equipment and automobiles	71,943	76,664
Property, plant and equipment, at cost	318,180	345,622
Less: accumulated depreciation	(103,306)	(110,509)
Property, plant and equipment, net	\$ 214,874	\$ 235,113

During 2014, 2015 and 2016, we recorded approximately \$9.2 million, \$10.4 million and \$11.5 million, respectively, of depreciation expense. During 2016, we acquired real estate for \$2.7 million for funeral home expansion projects and we purchased land and buildings at four funeral homes that were previously leased for approximately \$6.3 million. In addition, we acquired \$16.0 million of property, plant and equipment in connection with the six funeral home businesses we acquired during 2016, as further discussed in Note 3 to the Consolidated Financial Statements included herein.

Long-lived assets, such as property, plant and equipment subject to depreciation and amortization, are reviewed for impairment at least annually or whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with the Property, Plant and Equipment topic of the Accounting Standards Codification ("ASC") 360. This guidance requires that long-lived assets to be held and used are reported at the lower of their carrying amount or fair value. We assess long-lived assets for impairment whenever events or circumstances indicate that the carrying value may be greater than the fair value. We evaluate our long-lived assets for impairment when a funeral home business has negative earnings before interest, taxes, depreciation and amortization ("EBITDA") for four consecutive years and if there has been a decline in EBITDA in that same period. For our cemetery business, we analyze the long-lived assets for impairment if the business has a negative operating margin and a decline in operating margin over a four year period. We review our long-lived assets deemed held-for-sale to the point of recoverability. Assets to be disposed of and assets not expected to provide any future service potential are recorded at the lower of their carrying amount or fair value less estimated cost to sell. If we determine that the carrying value is not recoverable from the proceeds of the sale, we record an impairment at that time. For the year ended December 31, 2016, no impairments were identified on our long-lived assets.

### *Business Combinations*

Tangible and intangible assets acquired and liabilities assumed are recorded at fair value and goodwill is recognized for any difference between the price of the acquisition and fair value. We recognize the assets acquired, the liabilities assumed and any non-controlling interest in the acquiree at the acquisition date, measured at the fair value as of that date. Acquisition related costs are recognized separately from the acquisition and are expensed as incurred. We customarily estimate related transaction costs known at closing. To the extent that information not available to us at the closing date subsequently becomes available during the allocation period, we may adjust goodwill, intangible assets, assets or liabilities associated with the acquisition.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

During 2016, we acquired six funeral home businesses. We acquired two funeral home businesses in Houston, Texas in May 2016, one funeral home business in Madera, California in September 2016, one funeral home business in Brookfield, Wisconsin in November 2016 and two funeral home businesses in Burlington, North Carolina and Graham, North Carolina in November 2016.

See Note 3 to the Consolidated Financial Statements herein for further information concerning these acquisitions.

### *Goodwill*

The excess of the purchase price over the fair value of identifiable net assets of funeral home businesses acquired is recorded as goodwill. Goodwill has primarily been recorded in connection with the acquisition of funeral home businesses. Goodwill is tested annually for impairment by assessing the fair value of each of our reporting units. The funeral segment reporting units consist of our East, Central and West regions in the United States and we performed our annual impairment test of goodwill using information as of August 31, 2016.

Under current guidance, we are permitted to first assess qualitative factors to determine whether it is more-likely-than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. We conducted qualitative assessments in 2014 and 2015; however, for our 2016 annual impairment test, we performed the two-step goodwill impairment test. Our intent is to perform the two-step test at least once every three years unless certain indicators or events suggest otherwise.

The two-step goodwill impairment test involves estimates and management judgment. In the first step of our goodwill impairment testing, we compare the fair value of each reporting unit to its carrying value, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, the goodwill of that reporting unit is not considered impaired, and the second step is not required. We determine fair value for each reporting unit using both an income approach, weighted 90%, and a market approach, weighted 10%. Our methodology for determining an income-based fair value was based on discounting projected future cash flows. The projected future cash flows include assumptions concerning future operating performance and economic conditions that may differ from actual future cash flows discounted at a weighted average cost of capital for the Company based on market participant assumptions. Our methodology for determining a market approach fair value utilized the guideline public company method, in which we relied on market multiples of comparable companies operating in the same industry as the individual reporting units. In accordance with the guidance, if the fair value of the reporting unit is less than its carrying amount, the second step of the goodwill impairment testing needs to be performed. This step compares the implied fair value of goodwill to the carrying amount of the reporting unit's goodwill, and if the carrying amount exceeds the implied value, an impairment charge is recorded in an amount equal to the difference. For our 2016 annual impairment test, we performed the first step of our goodwill impairment testing and concluded that there was no impairment to goodwill for any of our reporting units.

In addition to our annual review, we assess the impairment of goodwill whenever events or changes in circumstances indicate that the carrying value of a reporting unit may be greater than fair value. Factors that could trigger an interim impairment review include, but are not limited to, significant adverse changes in the business climate which may be indicated by a decline in our market capitalization or decline in operating results.

For the year ended December 31, 2014, we recognized an impairment of approximately \$1.2 million for discontinued locations as the carrying value exceeded fair value. Upon receipt of a letter of intent to sell a location, we perform an analysis to determine if the net assets of the location exceed the sales price. If the net assets exceed the sales price, we record an impairment at the location level.

No impairments were recorded to our goodwill during the years ended December 31, 2015 and 2016. No such events or changes occurred between the testing date and year end to trigger a subsequent impairment review.

See Note 4 to the Consolidated Financial Statements herein for additional information related to our goodwill.

### *Intangible Assets*

Our intangible assets include tradenames resulting from acquisitions and are included in *Intangible and other non-current assets* on our Consolidated Balance Sheets. Our tradenames are considered to have an indefinite life and are not subject to amortization.

Under current guidance, we are permitted to first assess qualitative factors to determine whether it is more-likely-than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount in accordance with the guidance.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The Company elected to change the annual assessment date for indefinite lived intangible assets from December 31<sup>st</sup> to August 31<sup>st</sup> in 2016 because the change in date aligns with the Company's goodwill impairment test, which should create a synergy and enhance the quality of our indefinite lived intangible assets impairment analysis. We conducted qualitative assessments in 2014 and 2015; however, for our 2016 annual impairment test, we performed our quantitative impairment test using the relief from royalty method, using information as of August 31, 2016. Our intent is to perform the quantitative impairment test at least once every three years unless certain indicators or events suggest otherwise.

Our intangible asset impairment test involves estimates and management judgment. Under the relief from royalty method, the value of the tradename is measured through the value of the royalties that the Company is relieved from paying due to its ownership of the asset. We determine the fair value of the assets by discounting the cash flows that represent a savings in lieu of paying a royalty fee for use of the tradename. The discounted cash flow valuation uses projections of future cash flows and includes assumptions concerning future operating performance and economic conditions that may differ from actual future cash flows and the determination and application of an appropriate royalty rate and discount rate. To estimate the royalty rates for the individual tradename, we mainly relied on the profit split method, but also considered the comparable third-party license agreements and the return on asset method. A scorecard was used to assess the relative strength of the individual tradename to further adjust the royalty rates selected under the profit-split method for qualitative factors. For our 2016 annual impairment test, we performed our quantitative impairment testing and concluded that there was no impairment to intangible assets.

In addition to our annual review, we assess the impairment of intangible assets whenever certain events or changes in circumstances indicate that the carrying value of the intangible asset may be greater than the fair value. Factors that could trigger an interim impairment review include, but are not limited to, significant under-performance relative to historical or projected future operating results and significant negative industry or economic trends. During the third quarter of 2016, we recorded an impairment to tradenames of \$145,000 related to a funeral home business held for sale as the carrying value exceeded fair value. No other impairments were recorded to our intangible assets during the years ended December 31, 2014, 2015 and 2016.

See Note 12 to the Consolidated Financial Statements included herein for additional information on our intangible assets.

### *Divested and Discontinued Operations*

Effective January 1, 2015, we adopted the Financial Accounting Standards Board's ("FASB") guidance for reporting discontinued operations, which amended the definition of "discontinued operations" to include only disposals or held-for-sale classifications for components or groups of components of an entity that represent a strategic shift that either has or will have a major effect on an entity's operations or financial results. Examples of a strategic shift that has or will have a major effect on an entity's operations and financial results include a disposal of a major geographical area, line of business, equity method of investment or other parts of an entity. The new guidance also requires the disclosure of pre-tax income of disposals that do not qualify as discontinued operations.

During 2014, we sold a cemetery in Florida and two funeral homes, one in Ohio and one in Kentucky. For the year ended December 31, 2014, we recognized income from discontinued operations of \$0.4 million. We did not divest any of our funeral home or cemetery businesses in 2015. During 2016, we sold a funeral home business in Tennessee for \$1.35 million. The operating results of this business, as well as the loss on the sale are included within net income from continuing operations on our Consolidated Statements of Operations.

We continually review locations to optimize the sustainable earning power and return on our invested capital. These reviews could entail selling certain non-strategic businesses.

See Note 5 to the Consolidated Financial Statements herein for additional information concerning our discontinued operations.

### *Fair Value Measurements*

We measure the available-for-sale securities held by our funeral merchandise and service, cemetery merchandise and service, and cemetery perpetual care trusts at fair value on a recurring basis in accordance with the Fair Value Measurements Topic of the ASC. This guidance defines fair value as the price that would be received in the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The guidance establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

- Level 1 — inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets;
- Level 2 — inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument; and

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

- Level 3 — inputs to the valuation methodology are unobservable and significant to the fair value measurement.

We disclose the extent to which fair value is used to measure financial assets and liabilities, the inputs utilized in calculating valuation measurements, and the effect of the measurement of significant unobservable inputs on earnings, or changes in net assets, as of the measurement date. The fair value disclosures of transfers in and out of Levels 1 and 2 and the gross presentation of purchases, sales, issuances and settlements in the Level 3 reconciliation of the three-tier fair value hierarchy are also presented in Notes 6 and 10 to the Consolidated Financial Statements included herein. We currently do not have any assets that have fair values determined by Level 3 inputs and no liabilities measured at fair value. We have not elected to measure any additional financial instruments and certain other items at fair value that are not currently required to be measured at fair value.

To determine the fair value of assets and liabilities in an environment where the volume and level of activity for the asset or liability have significantly decreased, the exit price is used as the fair value measurement. For the year ended December 31, 2016, we did not incur significant decreases in the volume or level of activity of any asset or liability. We consider an impairment of debt and equity securities other-than-temporary unless (a) we have the ability and intent to hold an investment and (b) evidence indicating the cost of the investment is recoverable before we are more likely than not required to sell the investment. If an impairment is indicated, then an adjustment is made to reduce the carrying amount to fair value which is recorded as a reduction to either *Deferred preneed cemetery receipts held in trust*, *Deferred preneed funeral receipts held in trust* or *Care trusts' corpus* on our Consolidated Balance Sheets. For the years ended December 31, 2015 and 2016, we recorded impairment charges of \$1.8 million and \$2.3 million, respectively, for other-than-temporary declines in fair value related to unrealized losses on certain investments.

In the ordinary course of business, we are typically exposed to a variety of market risks. Currently, these are primarily related to changes in fair market values related to outstanding debts and changes in the values of securities associated with the preneed and perpetual care trusts. Management is actively involved in monitoring exposure to market risk and developing and utilizing risk management techniques when appropriate and when available for a reasonable price.

See Notes 6, 10 and 11 to the Consolidated Financial Statements herein for additional required disclosures concerning the fair value measurement of our financial assets and liabilities.

### *Presentation of Debt Issuance Costs*

Effective January 1, 2016, we adopted the FASB's new guidance on simplifying the presentation of debt issuance costs. The guidance requires that entities that have historically presented debt issuance costs as an asset, related to a recognized debt liability, will be required to present those costs as a direct deduction from the carrying value of the related debt liability. This presentation resulted in debt issuance costs being presented in the same way debt discounts have historically been addressed. Debt issuances costs of \$4.2 million and \$3.6 million have been presented as a deduction from the carrying value of the related liabilities in our Consolidated Balance Sheets as of December 31, 2015 and 2016, respectively. The amounts related to our Credit Facility were \$1.4 million and \$1.3 million as of December 31, 2015 and 2016, respectively. The amounts related to our Convertible Notes were \$2.8 million and \$2.3 million as of December 31, 2015 and 2016, respectively.

See Notes 13 and 14 to the Consolidated Financial Statements included herein for additional information concerning the presentation of debt issuance costs.

### *Income Taxes*

We and our subsidiaries file a consolidated United States Federal income tax return, separate income tax returns in 15 states in which we operate and combined or unitary income tax returns in 13 states in which we operate. We record deferred taxes for temporary differences between the tax basis and financial reporting basis of assets and liabilities.

We record a valuation allowance to reflect the estimated amount of deferred tax assets for which realization is uncertain. Management reviews the valuation allowance at the end of each quarter and makes adjustments if it is determined that it is more likely than not that the tax benefits will be realized.

We analyze tax benefits for uncertain tax positions and how they are to be recognized, measured, and derecognized in the financial statements; provide certain disclosures of uncertain tax matters; and specify how reserves for uncertain tax positions should be classified on the Consolidated Balance Sheets.

On August 1, 2014, we received notification that the Internal Revenue Service ("IRS") completed its examination of our tax year ended December 31, 2011. As a result, we recognized a tax benefit of \$1.7 million which reduced our effective tax rate for the year ended December 31, 2014. Additionally, we recognized a credit to interest expense of \$0.6 million related to the settled portion of the uncertain tax position.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

On August 15, 2016, we settled an open examination with the California Franchise Tax Board. As a result of paying the final assessment, we re-measured our tax liability for unrecognized tax benefits reflecting a reduction to our liability of \$0.2 million. On August 29, 2016, we received notification that the IRS completed its examination of our tax year ended December 31, 2013. As a result, we re-measured our tax liability for unrecognized tax benefits reflecting a reduction to our liability of \$0.6 million, which resulted in an increase to *Deferred tax liability* in the amount of \$0.6 million.

We do not have any unrecognized tax benefits recorded as of December 31, 2016 and we do not anticipate a material change in our unrecognized tax benefits during the next twelve months.

Effective January 1, 2016, we adopted the FASB's new guidance on Balance Sheet Classification of Deferred Taxes. The standard simplifies deferred tax reporting on the balance sheet by eliminating non-current and current classifications. The guidance requires all deferred tax assets and liabilities, along with related valuation allowances will be classified as non-current on the balance sheet. The guidance was applied prospectively and all deferred tax assets and liabilities, along with our valuation allowance are now classified as non-current at December 31, 2016.

See Note 16 to the Consolidated Financial Statements included herein for additional information concerning our income taxes.

### *Stock Plans and Stock-Based Compensation*

We have stock-based employee and director compensation plans under which we may grant restricted stock, stock options, performance awards and our employee stock purchase plan under which stock may be purchased. We recognize compensation expense in an amount equal to the fair value of the share-based awards expected to vest over the requisite service period. Fair value is determined on the date of the grant. The fair value of options or awards containing options is determined using the Black-Scholes valuation model. The fair value of the performance awards is determined using a Monte-Carlo simulation pricing model.

See Note 17 to the Consolidated Financial Statements included herein for additional information on our stock-based compensation plans.

### *Computation of Earnings Per Common Share*

Basic earnings per share is computed using the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed using the weighted average number of common and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares consist of stock options and our Convertible Notes.

Share-based awards that contain non-forfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are recognized as participating securities and included in the computation of both basic and diluted earnings per share. Our grants of restricted stock awards to our employees and directors are considered participating securities, and we have prepared our earnings per share calculations attributable to common stockholders to exclude outstanding unvested restricted stock awards, using the two-class method, in both the basic and diluted weighted average shares outstanding calculation.

The fully diluted weighted average shares outstanding for the years ended December 31, 2015 and 2016, and the corresponding calculation of fully diluted earnings per share, included approximately 0.3 million and 0.5 million shares that would have been issued upon the conversion of our convertible subordinated notes as a result of the application of the if-converted method prescribed by the FASB ASC 260. There were no shares that would have been issued upon conversion under the if-converted method for our convertible subordinated notes for the year ended December 31, 2014.

See Note 19 to the Consolidated Financial Statements included herein for the computation of per share earnings for the fiscal years ended December 31, 2014, 2015 and 2016.

### *Subsequent Events*

We have evaluated events and transactions during the period subsequent to December 31, 2016 through the date the financial statements were issued for potential recognition or disclosure in the accompanying financial statements covered by this report.



**2. RECENTLY ISSUED ACCOUNTING STANDARDS***Goodwill*

In January 2017, the FASB issued ASU, *Intangibles – Goodwill and Other (Topic 350)*. This ASU applies to all entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. The amendment simplifies subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test, which should reduce the cost and complexity of evaluating goodwill for impairment. An entity no longer will determine goodwill impairment by calculating the implied fair value of goodwill by assigning the fair value of a reporting unit to all of its assets and liabilities as if that reporting unit had been acquired in a business combination. Instead, impairment is defined as the amount by which the carrying value of the reporting unit exceeds its fair value, up to the total amount of goodwill. This ASU is effective for fiscal years beginning after December 15, 2019, with early adoption permitted. Our adoption of this ASU for our fiscal year beginning January 1, 2017 is not expected to have a material effect on our Consolidated Financial Statements.

*Stock-Based Compensation*

In March 2016, the FASB issued ASU, *Compensation – Stock Compensation (Topic 718)*. This ASU applies to all entities that issue share-based payment awards to their employees. The amendments in this ASU involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with earlier application permitted for all entities. Amendments related to the presentation of employee taxes paid on the statement of cash flows when an employer withholds shares to meet the minimum statutory withholding requirement should be applied retrospectively. Amendments requiring recognition of excess tax benefits and tax deficiencies in the income statement and the practical expedient for estimating expected term should be applied prospectively. An entity may elect to apply the amendments related to the presentation of excess tax benefits on the statement of cash flows using either a prospective transition method or a retrospective transition method. Our adoption of this ASU for our fiscal year beginning January 1, 2017 is not expected to have a material effect on our Consolidated Financial Statements.

*Inventory*

In July 2015, the FASB issued ASU, *Inventory – Simplifying the Measurement of Inventory (Topic 330)*. This ASU applies to all inventory, including inventory that is measured using the first-in, first-out (FIFO) or average cost method. This ASU does not apply to the last-in, first-out (LIFO) or the retail inventory method. This ASU requires an entity to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. This ASU is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years, and should be applied prospectively, with earlier application permitted as of the beginning of an interim or annual reporting period. Our adoption of this ASU for our fiscal year beginning January 1, 2017 is not expected to have a material effect on our Consolidated Financial Statements.

*Revenue Recognition*

In May 2014, the FASB issued ASU, *Revenue from Contracts with Customers. (Topic 606)*. ASC Topic 606 supersedes the revenue recognition requirements under ASC Topic 605, *Revenue Recognition*, and most industry-specific guidance throughout the Industry Topics of the ASC. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods or services. Under the new guidance, an entity is required to perform the following five steps: (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the entity satisfies a performance obligation. The new guidance will significantly enhance comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. Additionally, the guidance requires improved disclosures as to the nature, amount, timing and uncertainty of revenue that is recognized. On July 9, 2015, the FASB deferred the effective date by one year to annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2018.

We expect the adoption of this new accounting standard to affect our accounting for cemetery interment rights. Currently, our sales of cemetery interment rights are recorded as revenue in accordance with the retail land sales provisions for accounting for sales of real estate. This method provides for the recognition of revenue in the period in which the customer's cumulative payments exceed 10% of the contract price related to the interment right.

Under the new accounting standard, we will recognize the revenue in the period in which the sale occurs, irrespective of the cumulative payments received. The impact of this is not expected to have a material impact on our Consolidated Financial Statements. Upon revenue recognition, management will book an allowance for contract cancellations based on our previous

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

experience of cancellations and as such will reflect a one-time catch up for the allowance at January 1, 2018, which is not expected to have a material impact on our Consolidated Financial Statements.

Costs related to the sales of interment rights, which include real property and other costs related to cemetery development activities, will continue to be charged to operations using the specific identification method in the period in which the sale of the interment right is recognized as revenue. We do not expect the adoption of this accounting standard to materially affect our accounting for other revenue streams.

We are currently modifying our financial systems to provide accounting under the new method in addition to our current method and do not anticipate any business disruption related to adopting this guidance. We are continually evaluating the impact on our Consolidated Financial Statements with more recent financial information.

### *Cash Flows*

In August 2016, the FASB issued ASU, *Statement of Cash Flows (Topic 230)*. This ASU applies to all entities that are required to present a statement of cash flows under Topic 230. The amendments provide guidance on eight specific cash flow issues and includes clarification on how these items should be classified in the statement of cash flows and is designed to help eliminate diversity in practice as to where items are classified in the cash flow statement.

In November 2016, the FASB issued additional guidance on this Topic that requires amounts generally described as restricted cash and restricted cash equivalents to be included with cash and cash equivalents when reconciling the statement of cash flows. This ASU is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years, with earlier application permitted for all entities. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2018 and are currently evaluating the impact the adoption of this new accounting standard will have on our Consolidated Financial Statements.

### *Business Combinations*

In January 2017, the FASB issued Accounting Standards Update (“ASU”), *Business Combinations – Clarifying the Definition of a Business (Topic 805)*. This ASU applies to all entities that must determine whether they have acquired or sold a business. The amendments in this Update clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. This ASU is effective for fiscal years beginning after December 15, 2017, including the interim periods within those periods, with earlier application permitted. Our adoption of this ASU for our fiscal year beginning January 1, 2018 is not expected to have a material effect on our Consolidated Financial Statements.

### *Leases*

In February 2016, the FASB issued ASU, *Leases (Topic 842)*. This ASU addresses certain aspects of recognition, presentation, and disclosure of leases and applies to all entities that enter into a lease, with some specified scope exemptions. The amendments in this ASU aim to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. This ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with earlier application permitted for all entities. Both lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach, which recognizes the cumulative effect of initially applying the standard as an adjustment to retained earnings at the date of initial application. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2019 and are currently evaluating the impact the adoption of this new accounting standard will have on our Consolidated Financial Statements.

### *Financial Instruments*

In January 2016, the FASB issued ASU, *Financial Instruments – Overall - Recognition and Measurement of Financial Assets and Financial Liabilities (Topic 825)*. The amendments in this ASU address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments and apply to all entities that hold financial assets or owe financial liabilities. The amendments in this ASU also simplify the impairment assessment of equity investments without readily determinable fair values by requiring assessment for impairment qualitatively at each reporting period. That impairment assessment is similar to the qualitative assessment for long-lived assets, goodwill, and indefinite-lived intangible assets. This ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, with earlier application permitted for financial statements that have not been issued. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2018 and are currently evaluating the impact the adoption of this new accounting standard will have on our Consolidated Financial Statements.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

In June 2016, the FASB issued ASU, *Financial Instruments – Credit Losses (Topic 326)*. This ASU applies to all entities holding financial assets and net investment in leases that are not accounted for at fair value through net income. The main objective of the ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. This amendment replaces the incurred loss impairment methodology in the current standard with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. This ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years, with earlier application permitted for all entities. We plan to adopt the provisions of this ASU for our fiscal year beginning January 1, 2020 and are currently evaluating the impact the adoption of this new accounting standard will have on our Consolidated Financial Statements.

### 3. ACQUISITIONS

Our growth strategy depends on the execution of our Strategic Acquisition Model. We assess the strategic positioning of acquisition candidates based on certain criteria, which include volume and price trends, size of business, size of market, competitive standing, demographics, strength of brand and barriers to entry. The value of the acquisition candidates is based on the local market competitive dynamic which allows for appropriate and differentiating enterprise valuations and flexibility to customize the transactions.

On May 31, 2016, we acquired two funeral home businesses in Houston, Texas for approximately \$10.2 million. The purchase price consisted of \$6.72 million paid in cash at closing and \$6.5 million of deferred purchase price payments. The net present value of such future deferred purchase price payments for these two funeral home businesses was \$3.5 million, which was recorded in *Long-term debt* on our Consolidated Balance Sheets at acquisition. The deferred purchase price payments are being paid in 80 equal quarterly installments of \$81,250 which commenced on the closing date and then each September 1, December 1, March 1 and June 1 for the next 20 years.

On September 20, 2016, we acquired a funeral home business in Madera, California for \$5.65 million in cash.

On November 8, 2016, we acquired a funeral home business in Brookfield, Wisconsin for approximately \$6.8 million. The purchase price consisted of \$3.5 million paid in cash at closing and \$4.5 million of deferred purchase price payments. The net present value of such future deferred purchase price payments for the funeral home business was \$3.3 million, which was recorded in *Long-term debt* on our Consolidated Balance Sheets at acquisition. The deferred purchase price payments are being paid in equal annual installments of \$447,000 which commenced on the closing date and then each anniversary of the closing date for the next 10 years.

On November 15, 2016, we acquired two funeral home businesses; one in Burlington, North Carolina and one in Graham, North Carolina for approximately \$10.1 million. The purchase price consisted of \$8.0 million paid in cash at closing and \$2.5 million of deferred purchase price payments. The net present value of such future deferred purchase price payments for the funeral home business was \$2.1 million, which was recorded in *Long-term debt* on our Consolidated Balance Sheets at acquisition. The deferred purchase price payments are being paid in 60 equal monthly installments of \$41,667 which commenced on the first month following the closing date and then each month for the next 5 years.

The pro forma impact of these acquisitions on prior periods is not presented, as the impact is not material to our reported results. The results of the acquired businesses are included in the Company's results from the date of acquisition.

The following table summarizes the breakdown of the purchase price for the businesses described above (in thousands):

	Purchase Price
Cash paid	\$ 23,871
Deferred payments	8,884
Purchase Price	<u>\$ 32,755</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table summarizes the breakdown of the purchase price allocation for the businesses described above (in thousands):

	<b>Purchase Price Allocation</b>
Current assets	\$ 530
Property, plant & equipment	15,972
Goodwill	11,832
Intangible and other non-current assets	4,588
Assumed liabilities	(167)
Purchase Price	<u>\$ 32,755</u>

The intangible and other non-current assets relate to the fair value of tradenames and agreements not-to-compete, and the assumed liabilities relate to the obligations associated with certain financed automobiles we acquired.

The following table summarizes the fair value of the assets acquired for these businesses (in millions):

Acquisition Date	Type of Business	Market	Assets Acquired (Excluding Goodwill)	Goodwill Recorded	Liabilities and Debt Assumed
May 31, 2016	Two Funeral Homes	Houston, TX	\$ 7.0	\$ 3.3	\$ (0.1)
September 20, 2016	One Funeral Home	Madera, CA	\$ 3.7	\$ 1.9	\$ —
November 8, 2016	One Funeral Home	Brookfield, WI	\$ 5.7	\$ 1.2	\$ (0.1)
November 15, 2016	Two Funeral Homes	Burlington/Graham, NC	\$ 4.7	\$ 5.4	\$ —

As of December 31, 2016, our accounting for our 2016 acquisitions is complete. See Note 12 to the Consolidated Financial Statements included herein for additional information on our intangible and other non-current assets.

The following table summarizes the fair value of the assets acquired during 2015 (in thousands):

	<b>Purchase Price Allocation</b>
Current assets	\$ 92
Property, plant & equipment	5,966
Goodwill	6,974
Intangible and other non-current assets	1,986
Purchase Price	<u>\$ 15,018</u>

The following table summarizes the fair value of the assets acquired during 2015 (in millions):

Acquisition Date	Type of Business	Market	Assets Acquired (Excluding Goodwill)	Goodwill Recorded	Liabilities and Debt Assumed
February 25, 2015	One Funeral Home	Clarksville, TN	\$ 4.9	\$ 3.9	\$ —
November 17, 2015	One Funeral Home	Wakeforest, NC	\$ 3.1	\$ 3.1	\$ —

### 4. GOODWILL

Many of the former owners and staff of our acquired funeral homes and certain cemeteries have provided high quality service to families for generations. The resulting loyalty often represents a substantial portion of the value of a business. The excess of the purchase price over the fair value of identifiable net assets of funeral home businesses acquired is recorded as goodwill. Goodwill has primarily been recorded in connection with the acquisition of funeral home businesses.

Under current guidance, we are permitted to first assess qualitative factors to determine whether it is more-likely-than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. We conducted qualitative assessments in 2014 and 2015; however, for our 2016 annual impairment test, we performed the two-step goodwill impairment test. Our intent is to perform the two-step test at least once every three years unless certain indicators or events suggest otherwise. See Note 1 to the Consolidated Financial Statements included

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

herein, for a discussion of the methodology used for our annual goodwill impairment test. Based on our 2016 impairment test, we concluded that there was no impairment to goodwill.

The following table presents changes in goodwill in the accompanying Consolidated Balance Sheets for the years ended December 31, 2015 and 2016 (in thousands):

	December 31, 2015	December 31, 2016
Goodwill at the beginning of year	\$ 257,442	\$ 264,416
Increase in goodwill related to acquisitions	6,974	11,832
Decrease in goodwill related to divestitures	—	(761)
Goodwill at the end of the year	<u>\$ 264,416</u>	<u>\$ 275,487</u>

The \$11.8 million increase to goodwill represents the goodwill recorded in connection with our 2016 acquisitions. The \$0.8 million decrease to goodwill relates to a divested business in Tennessee during the fourth quarter of 2016.

### 5. DIVESTED AND DISCONTINUED OPERATIONS

Effective January 1, 2015, we adopted the FASB's new guidance for reporting discontinued operations which amended the definition of "discontinued operations" to include only disposals or held-for-sale classifications for components or groups of components of an entity that represent a strategic shift that either has or will have a major effect on an entity's operations or financial results. Examples of a strategic shift that has or will have a major effect on an entity's operations and financial results include a disposal of a major geographical area, line of business, equity method of investment or other parts of an entity. The new guidance also requires the disclosure of pre-tax income of disposals that do not qualify as discontinued operations.

We did not divest any of our funeral home or cemetery businesses in 2015. During 2016, we sold a funeral home business in Tennessee for \$1.35 million. We continually review locations to optimize the sustainable earning power and return on our invested capital. These reviews could entail selling certain non-strategic businesses.

The operating results of this divested business, as well as the loss on the sale are included within net income from continuing operations on our Consolidated Statements of Operations and is reflected in the table below (in thousands):

	Year Ended December 31,		
	2014	2015	2016
Revenues	\$ —	\$ —	\$ 744
Operating income	—	—	314
Net loss on disposal	—	—	(29)
Income tax provision	—	—	(112)
Net income from divested operations	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 173</u>

During 2014, we sold a cemetery in Florida and two funeral homes, one in Ohio and one in Kentucky. The operating results of these discontinued businesses, as well as any impairments and net gains on the disposals, presented within discontinued operations on our Consolidated Statements of Operations, along with the income tax effect, were as follows (in thousands):

	Year Ended December 31,		
	2014	2015	2016
Revenues	\$ 817	\$ —	\$ —
Operating income	235	—	—
Impairment	(1,180)	—	—
Net gain on disposal	1,594	—	—
Income tax provision	(257)	—	—
Income from discontinued operations, net of tax	<u>\$ 392</u>	<u>\$ —</u>	<u>\$ —</u>

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 6. PRENEED TRUST INVESTMENTS

### *Preneed Cemetery Trust Investments*

Preneed cemetery trust investments represent trust fund assets that we are generally permitted to withdraw as the services and merchandise are provided to customers. Preneed cemetery contracts are secured by payments from customers, less amounts not required by law to be deposited into trust. Preneed cemetery trust investments are reduced by the trust earnings we have been allowed to withdraw in certain states prior to our performance.

The components of *Preneed cemetery trust investments* on our Consolidated Balance Sheets at December 31, 2015 and 2016 were as follows (in thousands):

	December 31, 2015	December 31, 2016
Preneed cemetery trust investments, at market value	\$ 65,486	\$ 71,834
Less: allowance for contract cancellation	(2,195)	(2,138)
Preneed cemetery trust investments, net	<u>\$ 63,291</u>	<u>\$ 69,696</u>

Upon cancellation of a preneed cemetery contract, a customer is generally entitled to receive a refund of the corpus, and in some cases, some or all of the earnings held in trust. In certain jurisdictions, we may be obligated to fund any shortfall if the amounts deposited by the customer exceed the funds in trust, including some or all investment income. As a result, when realized or unrealized losses of a trust result in the trust being under-funded, we assess whether we are responsible for replenishing the corpus of the trust, in which case a loss provision is recorded. At December 31, 2016, none of our preneed cemetery trust investments were under-funded.

Earnings from our preneed cemetery trust investments are recognized in revenue when a service is performed or merchandise is delivered. Trust management fees charged by CSV RIA are included as revenue in the period in which they are earned.

Where quoted prices are available in an active market, investments held by the trusts are classified as Level 1 investments pursuant to the three-level valuation hierarchy. Our Level 1 investments include cash and common stock. Where quoted market prices are not available for the specific security, fair values are estimated by using quoted prices of similar securities in active markets or other inputs other than quoted prices that can corroborate observable market data. These investments are fixed income securities including municipal bonds, foreign debt, corporate debt, preferred stock, mortgage-backed securities and fixed income mutual funds, all of which are classified within Level 2 of the valuation hierarchy. We review and update our fair value hierarchy classifications quarterly. There were no transfers between Levels 1 and 2 in the year ended December 31, 2016. There are no Level 3 investments in the preneed cemetery trust investment portfolio. See Note 11 to the Consolidated Financial Statements included herein for further information of the fair value measurement and the three-level valuation hierarchy.

The cost and fair market values associated with preneed cemetery trust investments at December 31, 2016 are detailed below (in thousands):

	Fair Value Hierarchy Level	Cost	Unrealized Gains	Unrealized Losses	Fair Market Value
Cash and money market accounts	1	\$ 10,852	\$ —	\$ —	\$ 10,852
Fixed income securities:					
Municipal bonds	2	496	18	(4)	\$ 510
Foreign debt	2	7,574	160	(656)	7,078
Corporate debt	2	20,621	1,569	(1,123)	21,067
Preferred stock	2	16,287	8	(947)	15,348
Mortgage-backed securities	2	949	372	(4)	1,317
Common stock	1	13,250	2,191	(1,838)	13,603
Mutual funds:					
Fixed income	2	\$ 1,223	107	—	\$ 1,330
Trust securities		<u>\$ 71,252</u>	<u>\$ 4,425</u>	<u>\$ (4,572)</u>	<u>\$ 71,105</u>
Accrued investment income		<u>\$ 729</u>			<u>\$ 729</u>
Preneed cemetery trust investments					<u>\$ 71,834</u>
Market value as a percentage of cost					<u>99.8%</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The estimated maturities of the fixed income securities included above are as follows (in thousands):

Due in one year or less	\$ 198
Due in one to five years	6,729
Due in five to ten years	5,813
Thereafter	32,580
Total fixed income securities	<u>\$ 45,320</u>

The cost and market values associated with preneed cemetery trust investments at December 31, 2015 are detailed below (in thousands):

	Fair Value Hierarchy Level	Cost	Unrealized Gains	Unrealized Losses	Fair Market Value
Cash and money market accounts	1	\$ 8,296	\$ —	\$ —	\$ 8,296
Fixed income securities:					
Municipal bonds	2	458	—	(63)	\$ 395
Foreign debt	2	4,803	—	(695)	4,108
Corporate debt	2	22,968	85	(4,279)	18,774
Preferred stock	2	16,236	29	(885)	15,380
Mortgage-backed securities	2	—	—	—	—
Common stock	1	20,387	682	(3,161)	17,908
Trust securities		<u>\$ 73,148</u>	<u>\$ 796</u>	<u>\$ (9,083)</u>	<u>\$ 64,861</u>
Accrued investment income		<u>\$ 625</u>			<u>\$ 625</u>
Preneed cemetery trust investments					<u>\$ 65,486</u>
Market value as a percentage of cost					<u>88.7%</u>

We determine whether or not the assets in the preneed cemetery trust investments have an other-than-temporary impairment on a security-by-security basis. This assessment is made based upon a number of criteria including the length of time a security has been in a loss position, changes in market conditions and concerns related to the specific issuer. If a loss is considered to be other-than-temporary, the cost basis of the security is adjusted downward to its fair market value. Any reduction in the cost basis of the investment due to an other-than-temporary impairment is likewise recorded as a reduction in *Deferred preneed cemetery receipts held in trust* on our Consolidated Balance Sheets. For the years ended December 31, 2015 and 2016, we recorded a \$0.7 million and \$0.9 million impairment for other-than-temporary declines in fair value related to unrealized losses on certain investments, respectively. There is no impact on earnings until such time that the loss is realized in the trusts, allocated to the preneed contracts and the services are performed or the merchandise is delivered causing the contract to be withdrawn from the trust in accordance with state regulations.

At December 31, 2016, we had certain investments within our preneed cemetery trust investments that had tax lots in loss positions for more than one year. Based on our analyses of these securities, the companies' businesses and current market conditions, we determined that these investment losses were temporary in nature.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Our cemetery merchandise and service trust investment unrealized losses, their associated fair market values, and the duration of unrealized losses as of December 31, 2016 are shown in the following tables (in thousands):

	December 31, 2016					
	In Loss Position Less than 12 months		In Loss Position Greater than 12 months		Total	
	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses
Fixed income securities:						
Municipal bonds	\$ 228	\$ (4)	\$ —	\$ —	\$ 228	\$ (4)
Foreign debt	2,523	(180)	2,868	(475)	5,391	(655)
Corporate debt	6,939	(233)	2,168	(890)	9,107	(1,123)
Preferred stock	3,217	(121)	11,635	(826)	14,852	(947)
Mortgage-backed securities	51	(5)	—	—	51	(5)
Common stock	2,608	(202)	3,385	(1,636)	5,993	(1,838)
Total temporary impaired securities	<u>\$ 15,566</u>	<u>\$ (745)</u>	<u>\$ 20,056</u>	<u>\$ (3,827)</u>	<u>\$ 35,622</u>	<u>\$ (4,572)</u>

Our cemetery merchandise and service trust investment unrealized losses, their associated fair market values, and the duration of unrealized losses as of December 31, 2015 are shown in the following tables (in thousands):

	December 31, 2015					
	In Loss Position Less than 12 months		In Loss Position Greater than 12 months		Total	
	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses
Fixed income securities:						
Municipal bonds	\$ 395	\$ (63)	\$ —	\$ —	\$ 395	\$ (63)
Foreign debt	3,680	(384)	406	(312)	4,086	(696)
Corporate debt	14,468	(2,992)	3,056	(1,287)	17,524	(4,279)
Preferred stock	10,285	(436)	5,168	(448)	15,453	(884)
Common stock	12,029	(1,989)	3,564	(1,172)	15,593	(3,161)
Total temporary impaired securities	<u>\$ 40,857</u>	<u>\$ (5,864)</u>	<u>\$ 12,194</u>	<u>\$ (3,219)</u>	<u>\$ 53,051</u>	<u>\$ (9,083)</u>

Preneed cemetery trust investment security transactions recorded in *Interest expense* on our Consolidated Statements of Operations for the years ended December 31, 2014, 2015 and 2016 were as follows (in thousands):

	Year ended December 31,		
	2014	2015	2016
Investment income	\$ 2,840	\$ 2,562	\$ 2,250
Realized gains	5,712	2,952	2,141
Realized losses	(2,789)	(3,671)	(6,559)
Expenses and taxes	(1,716)	(1,790)	(1,266)
Decrease (increase) in deferred preneed cemetery receipts held in trust	(4,047)	(53)	3,434
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Purchases and sales of investments in the preneed cemetery trusts for the years ended December 31, 2014, 2015 and 2016 were as follows (in thousands):

	Year ended December 31,		
	2014	2015	2016
Purchases	\$ (53,443)	\$ (26,757)	\$ (25,643)
Sales	58,022	23,141	25,846

### *Preneed Funeral Trust Investments*

Preneed funeral trust investments represent trust fund assets that we are permitted to withdraw as services and merchandise are provided to customers. Preneed funeral contracts are secured by payments from customers, less amounts not required by law to be deposited into trust. Preneed funeral trust investments are reduced by the trust earnings we have been allowed to withdraw in certain states prior to our performance.

The components of *Preneed funeral trust investments* on our Consolidated Balance Sheets at December 31, 2015 and 2016 were as follows (in thousands):

	December 31, 2015	December 31, 2016
Preneed funeral trust investments, at market value	\$ 88,444	\$ 91,980
Less: allowance for contract cancellation	(2,891)	(2,740)
Preneed funeral trust investments, net	<u>\$ 85,553</u>	<u>\$ 89,240</u>

Upon cancellation of a preneed funeral contract, a customer is generally entitled to receive a refund of the corpus and some or all of the earnings held in trust. In certain jurisdictions, we may be obligated to fund any shortfall if the amounts deposited by the customer exceed the funds in trust, including some or all investment income. As a result, when realized or unrealized losses of a trust result in the trust being under-funded, we assess whether we are responsible for replenishing the corpus of the trust, in which case a loss provision is recorded. At December 31, 2016, none of our preneed funeral trust investments were under-funded.

Earnings from our preneed funeral trust investments are recognized in revenue when a service is performed or merchandise is delivered. Trust management fees charged by CSV RIA are included in revenue in the period in which they are earned.

Where quoted prices are available in an active market, investments held by the trusts are classified as Level 1 investments pursuant to the three-level valuation hierarchy. Our Level 1 investments include cash, U.S. treasury debt and common stock. Where quoted market prices are not available for the specific security, then fair values are estimated by using quoted prices of similar securities in active markets or other inputs other than quoted prices that can corroborate observable market data. These investments are fixed income securities including U.S. treasury debt, municipal bonds, foreign debt, corporate debt, preferred stocks, mortgage-backed securities and fixed income mutual funds and other investments, all of which are classified within Level 2 of the valuation hierarchy. We review and update our fair value hierarchy classifications quarterly. There were no other transfers between Levels 1 and 2 for the year ended December 31, 2016. There are no Level 3 investments in the preneed funeral trust investment portfolio. See Note 11 to the Consolidated Financial Statements included herein for further information of the fair value measurement and the three-level valuation hierarchy.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The cost and fair market values associated with preneed funeral trust investments at December 31, 2016 are detailed below (in thousands):

	Fair Value Hierarchy Level	Cost	Unrealized Gains	Unrealized Losses	Fair Market Value
Cash and money market accounts	1	\$ 22,787	\$ —	\$ —	\$ 22,787
Fixed income securities:					
U.S. treasury debt	1	1,491	21	(10)	1,502
Municipal bonds	2	447	17	(4)	460
Foreign debt	2	7,692	170	(677)	7,185
Corporate debt	2	21,454	1,566	(1,134)	21,886
Preferred stock	2	17,037	64	(970)	16,131
Mortgage-backed securities	2	1,165	400	(5)	1,560
Common stock	1	13,675	2,256	(1,850)	14,081
Mutual funds:					
Fixed income	2	2,124	115	(66)	2,173
Other investments	2	3,463	—	—	3,463
Trust securities		<u>\$ 91,335</u>	<u>\$ 4,609</u>	<u>\$ (4,716)</u>	<u>\$ 91,228</u>
Accrued investment income		<u>\$ 752</u>			<u>\$ 752</u>
Preneed funeral trust investments					<u>\$ 91,980</u>
Market value as a percentage of cost					<u>99.9%</u>

The estimated maturities of the fixed income securities included above are as follows (in thousands):

Due in one year or less	\$ 212
Due in one to five years	8,105
Due in five to ten years	6,276
Thereafter	34,131
Total fixed income securities	<u>\$ 48,724</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The cost and market values associated with preneed funeral trust investments at December 31, 2015 are detailed below (in thousands):

	Fair Value Hierarchy Level	Cost	Unrealized Gains	Unrealized Losses	Fair Market Value
Cash and money market accounts	1	\$ 21,458	\$ —	\$ —	\$ 21,458
Fixed income securities:					
U.S. treasury debt	1	1,492	24	(12)	1,504
Municipal bonds	2	478	—	(66)	412
Foreign debt	2	4,938	—	(711)	4,227
Corporate debt	2	24,787	133	(4,711)	20,209
Preferred stock	2	17,496	158	(914)	16,740
Mortgage-backed securities	2	273	4	(4)	273
Common stock	1	20,864	738	(3,114)	18,488
Mutual funds:					
Fixed income	2	959	—	(82)	877
Other investments	2	3,598	—	(30)	3,568
Trust securities		<u>\$ 96,343</u>	<u>\$ 1,057</u>	<u>\$ (9,644)</u>	<u>\$ 87,756</u>
Accrued investment income		<u>\$ 688</u>			<u>\$ 688</u>
Preneed funeral trust investments					<u>\$ 88,444</u>
Market value as a percentage of cost					<u>91.1%</u>

We determine whether or not the assets in the preneed funeral trust investments have other-than-temporary impairments on a security-by-security basis. This assessment is made based upon a number of criteria including the length of time a security has been in a loss position, changes in market conditions and concerns related to the specific issuer. If a loss is considered to be other-than-temporary, the cost basis of the security is adjusted downward to its fair market value. Any reduction in the cost basis of the investment due to an other-than-temporary impairment is likewise recorded as a reduction to *Deferred preneed funeral receipts held in trust* on our Consolidated Balance Sheets. For the years ended December 31, 2015 and 2016, we recorded a \$0.6 million and \$0.9 million impairment for other-than-temporary declines in fair value related to unrealized losses on certain investments, respectively. There is no impact on earnings until such time that the loss is realized in the trusts, allocated to preneed contracts and the services are performed or the merchandise is delivered causing the contract to be withdrawn from the trust in accordance with state regulations.

At December 31, 2016, we had certain investments within our preneed funeral trust investments that had tax lots in loss positions for more than one year. Based on our analyses of these securities, the companies' businesses and current market conditions, we determined that these investment losses were temporary in nature.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Our preneed funeral trust investment unrealized losses, their associated fair market values, and the duration of unrealized losses as of December 31, 2016 are shown in the following tables (in thousands):

	December 31, 2016					
	In Loss Position Less than 12 months		In Loss Position Greater than 12 months		Total	
	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses
Fixed income securities:						
U.S. debt	\$ 834	\$ (10)	\$ —	\$ —	\$ 834	\$ (10)
Municipal bonds	244	(5)	—	—	244	(5)
Foreign debt	2,654	(186)	2,905	(490)	5,559	(676)
Corporate debt	6,977	(215)	2,234	(919)	9,211	(1,134)
Preferred stock	3,420	(128)	11,750	(842)	15,170	(970)
Mortgage-backed securities	55	(5)	11	(1)	66	(6)
Mutual funds:						
Equity	2,795	(216)	3,390	(1,634)	6,185	(1,850)
Equity and other	—	—	—	—	—	—
Fixed income	97	(7)	644	(58)	741	(65)
Other investments	—	—	—	—	—	—
Total temporary impaired securities	<u>\$ 17,076</u>	<u>\$ (772)</u>	<u>\$ 20,934</u>	<u>\$ (3,944)</u>	<u>\$ 38,010</u>	<u>\$ (4,716)</u>

Our preneed funeral trust investment unrealized losses, their associated fair market values, and the duration of unrealized losses as of December 31, 2015 are shown in the following tables (in thousands):

	December 31, 2015					
	In Loss Position Less than 12 months		In Loss Position Greater than 12 months		Total	
	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses
Fixed income securities:						
U.S. debt	\$ —	\$ —	\$ 1,504	\$ (12)	\$ 1,504	\$ (12)
Municipal bonds	413	(66)	—	—	413	(66)
Foreign debt	3,763	(392)	416	(319)	4,179	(711)
Corporate debt	15,929	(3,294)	3,364	(1,417)	19,293	(4,711)
Preferred stock	10,623	(451)	5,338	(463)	15,961	(914)
Mortgage-backed securities	—	—	272	(4)	272	(4)
Mutual funds:						
Equity	11,848	(1,959)	3,510	(1,154)	15,358	(3,113)
Fixed income	1	—	876	(82)	877	(82)
Other investments	—	—	42	(31)	42	(31)
Total temporary impaired securities	<u>\$ 42,577</u>	<u>\$ (6,162)</u>	<u>\$ 15,322</u>	<u>\$ (3,482)</u>	<u>\$ 57,899</u>	<u>\$ (9,644)</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Preneed funeral trust investment security transactions recorded in *Interest expense* on our Consolidated Statements of Operations for the years ended December 31, 2014, 2015 and 2016 were as follows (in thousands):

	Year ended December 31,		
	2014	2015	2016
Investment income	\$ 3,065	\$ 2,819	\$ 2,344
Realized gains	7,184	3,931	2,287
Realized losses	(2,313)	(3,979)	(6,642)
Expenses and taxes	(1,470)	(988)	(1,174)
Decrease (increase) in deferred preneed funeral receipts held in trust	(6,466)	(1,783)	3,185
	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

Purchases and sales of investments in the preneed funeral trusts for the years ended December 31, 2014, 2015 and 2016 were as follows (in thousands):

	Year ended December 31,		
	2014	2015	2016
Purchases	\$ (57,297)	\$ (26,021)	\$ (26,457)
Sales	60,352	42,582	27,425

### 7. PRENEED CEMETERY RECEIVABLES

Preneed sales of cemetery interment rights and related products and services are usually financed through interest-bearing installment sales contracts, generally with terms of up to five years with such interest income reflected as *Preneed cemetery finance charges*. In substantially all cases, we receive an initial down payment at the time the contract is signed. At December 31, 2016, our total financed preneed receivables were \$39.0 million, of which \$28.7 million and \$10.3 million were for cemetery interment rights and for merchandise and services, respectively. These amounts are presented on our consolidated balance sheet as \$11.4 million in *Accounts receivable* and \$27.6 million within *Preneed receivables* and exclude unearned finance charges and allowance for contract cancellations. At December 31, 2015, our total financed preneed receivables were \$36.5 million, of which \$26.8 million and \$9.7 million were for cemetery interment rights and for merchandise and services, respectively. These amounts are presented on our consolidated balance sheet as \$11.2 million in *Accounts receivable* and \$25.3 million within *Preneed receivables* and exclude unearned finance charges and allowance for contract cancellations. The unearned finance charges associated with these receivables was \$5.2 million and \$5.7 million at December 31, 2015 and 2016, respectively.

We determine an allowance for customer cancellations and refunds on contracts in which revenue has been recognized on sales of cemetery interment rights. We have a collections policy where past due notifications are sent to the customer beginning at 15 days past due and periodically thereafter until the contract is cancelled or payment is received. We reserve 100% of the receivables on contracts in which the revenue has been recognized and payments are 90 days past due or more, which was approximately 4.7% of the total receivables on recognized sales at December 31, 2016. An allowance is recorded at the date that the contract is executed and periodically adjusted thereafter based upon actual collection experience at the business level. For the years ending December 31, 2015 and 2016, the changes to the allowance for contract cancellations were as follows (in thousands):

	As of December 31,	
	2015	2016
Beginning balance	\$ 2,140	\$ 1,765
Write-offs and cancellations	(1,462)	(1,332)
Provision	1,087	1,428
Ending balance	<u>\$ 1,765</u>	<u>\$ 1,861</u>

The aging of past due financing receivables as of December 31, 2016 was as follows (in thousands):

	31-60 Past Due	61-90 Past Due	91-120 Past Due	>120 Past Due	Total Past Due	Current	Total Financing Receivables
Recognized revenue	\$ 674	\$ 356	\$ 233	\$ 1,086	\$ 2,349	\$ 26,003	\$ 28,352
Deferred revenue	310	112	86	316	824	9,810	10,634
Total contracts	<u>\$ 984</u>	<u>\$ 468</u>	<u>\$ 319</u>	<u>\$ 1,402</u>	<u>\$ 3,173</u>	<u>\$ 35,813</u>	<u>\$ 38,986</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The aging of past due financing receivables as of December 31, 2015 was as follows (in thousands):

	31-60 Past Due	61-90 Past Due	91-120 Past Due	>120 Past Due	Total Past Due	Current	Total Financing Receivables
Recognized revenue	\$ 758	\$ 446	\$ 225	\$ 1,061	\$ 2,490	\$ 22,742	\$ 25,232
Deferred revenue	273	207	103	335	918	10,380	11,298
Total contracts	<u>\$ 1,031</u>	<u>\$ 653</u>	<u>\$ 328</u>	<u>\$ 1,396</u>	<u>\$ 3,408</u>	<u>\$ 33,122</u>	<u>\$ 36,530</u>

### 8. RECEIVABLES FROM PRENEED TRUSTS

The receivables from preneed trusts represent assets in trusts which are controlled and operated by third parties in which we do not have a controlling financial interest (less than 50%) in the trust assets. We account for these investments at cost. As of December 31, 2015 and 2016, receivables from preneed trusts were as follows (in thousands):

	December 31, 2015	December 31, 2016
Prenneed trust funds, at cost	\$ 13,963	\$ 14,658
Less: allowance for contract cancellation	(419)	(440)
Receivables from preneed trusts, net	<u>\$ 13,544</u>	<u>\$ 14,218</u>

The following summary reflects the composition of the assets held in trust and controlled by third parties to satisfy our future obligations under preneed arrangements related to the preceding contracts at December 31, 2015 and 2016. The cost basis includes reinvested interest and dividends that have been earned on the trust assets. Fair value includes unrealized gains and losses on trust assets.

The composition of the preneed trust funds at December 31, 2016 were as follows (in thousands):

	Historical Cost Basis	Fair Value
As of December 31, 2016		
Cash and cash equivalents	\$ 3,378	\$ 3,378
Fixed income investments	8,809	8,809
Mutual funds and common stocks	2,455	2,463
Annuities	16	16
Total	<u>\$ 14,658</u>	<u>\$ 14,666</u>

The composition of the preneed trust funds at December 31, 2015 were as follows (in thousands):

	Historical Cost Basis	Fair Value
As of December 31, 2015		
Cash and cash equivalents	\$ 2,898	\$ 2,898
Fixed income investments	8,423	8,426
Mutual funds and common stocks	2,626	2,625
Annuities	16	16
Total	<u>\$ 13,963</u>	<u>\$ 13,965</u>

### 9. CONTRACTS SECURED BY INSURANCE

Certain preneed funeral contracts are secured by life insurance contracts. Generally, the proceeds of the life insurance policies have been assigned to us and will be paid upon the death of the insured. The proceeds will be used to satisfy the beneficiary's obligations under the preneed contract for services and merchandise. Prenneed funeral contracts secured by insurance policies totaled \$324.0 million and \$357.4 million at December 31, 2015 and 2016, respectively, and are not included on our Consolidated Balance Sheets.



# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 10. CEMETERY PERPETUAL CARE TRUST INVESTMENTS

*Care trusts' corpus* on our Consolidated Balance Sheets represent the corpus of those trusts plus undistributed income. The components of Care trusts' corpus as of December 31, 2015 and 2016 were as follows (in thousands):

	December 31, 2015	December 31, 2016
Trust assets, at market value	\$ 43,127	\$ 46,889
Obligations due from trust	(711)	(599)
Care trusts' corpus	<u>\$ 42,416</u>	<u>\$ 46,290</u>

We are required by various state laws to pay a portion of the proceeds from the sale of cemetery property interment rights into perpetual care trust funds. The income earned from these perpetual care trusts offsets maintenance expenses for cemetery property and memorials. This trust fund income is recognized, as earned, in *Revenues: Cemetery*. Trust management fees charged by CSV RIA are included in revenue in the period in which they are earned. At December 31, 2016, none of our cemetery perpetual care trust investments were under-funded.

Where quoted prices are available in an active market, investments held by the trusts are classified as Level 1 investments pursuant to the three-level valuation hierarchy. Our Level 1 investments include cash and common stock. Where quoted market prices are not available for the specific security, then fair values are estimated by using quoted prices of similar securities in active markets or other inputs other than quoted prices that can corroborate observable market data. These investments are municipal bonds, foreign debt, corporate debt, preferred stock, mortgage-backed securities and fixed income mutual funds, all of which are classified within Level 2 of the valuation hierarchy. There were no transfers between Levels 1 and 2 for the year ended December 31, 2016. There are no Level 3 investments in the cemetery perpetual care trust investment portfolio. See Note 11 to the Consolidated Financial Statements included herein for further information of the fair value measurement and the three-level valuation hierarchy.

The following table reflects the cost and fair market values associated with the trust investments held in perpetual care trust funds at December 31, 2016 (in thousands):

	Fair Value Hierarchy Level	Cost	Unrealized Gains	Unrealized Losses	Fair Market Value
Cash and money market accounts	1	\$ 6,522	\$ —	\$ —	\$ 6,522
Fixed income securities:					
Municipal bonds	2	365	13	(3)	375
Foreign debt	2	5,100	99	(435)	4,764
Corporate debt	2	13,715	966	(821)	13,860
Preferred stock	2	11,323	5	(664)	10,664
Mortgage-backed securities	2	569	223	(3)	789
Common stock	1	8,259	1,382	(1,146)	8,495
Mutual funds:					
Fixed income	2	855	76	—	931
Trust securities		<u>\$ 46,708</u>	<u>\$ 2,764</u>	<u>\$ (3,072)</u>	<u>\$ 46,400</u>
Accrued investment income		<u>\$ 489</u>			<u>\$ 489</u>
Cemetery perpetual care investments					<u>\$ 46,889</u>
Market value as a percentage of cost					<u>99.3%</u>

The estimated maturities of the fixed income securities included above are as follows (in thousands):

Due in one year or less	\$ 119
Due in one to five years	4,073
Due in five to ten years	4,083
Thereafter	22,177
Total fixed income securities	<u>\$ 30,452</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table reflects the cost and market values associated with the trust investments held in perpetual care trust funds at December 31, 2015 (in thousands):

	Fair Value Hierarchy Level	Cost	Unrealized Gains	Unrealized Losses	Fair Market Value
Cash and money market accounts	1	\$ 5,472	\$ —	\$ —	\$ 5,472
Fixed income securities:					
Municipal bonds	2	325	—	(45)	280
Foreign debt	2	3,232	—	(480)	2,752
Corporate debt	2	16,216	57	(3,094)	13,179
Preferred stock	2	11,263	20	(611)	10,672
Common stock	1	11,945	393	(1,939)	10,399
Trust securities		<u>\$ 48,453</u>	<u>\$ 470</u>	<u>\$ (6,169)</u>	<u>\$ 42,754</u>
Accrued investment income		<u>\$ 373</u>			<u>\$ 373</u>
Cemetery perpetual care investments					<u>\$ 43,127</u>
Market value as a percentage of cost					<u>88.2%</u>

We determine whether or not the assets in the cemetery perpetual care trusts have an other-than-temporary impairment on a security-by-security basis. This assessment is made based upon a number of criteria including the length of time a security has been in a loss position, changes in market conditions and concerns related to the specific issuer. If a loss is considered to be other-than-temporary, the cost basis of the security is adjusted downward to its fair market value. Any reduction in the cost basis due to an other-than-temporary impairment is also recorded as a reduction to *Care trusts' corpus*. For both years ended December 31, 2015 and 2016, we recorded a \$0.4 million impairment charge for other-than-temporary declines in fair value related to unrealized losses on certain investments.

At December 31, 2016, we had certain investments within our perpetual care trust investments that had tax lots in loss positions for more than one year. Based on our analyses of these securities, the companies' businesses and current market conditions, we determined that these investments losses are temporary in nature.

Our perpetual care trust investment unrealized losses, their associated fair market values, and the duration of unrealized losses as of December 31, 2016 are shown in the following tables (in thousands):

	December 31, 2016					
	In Loss Position Less than 12 months		In Loss Position Greater than 12 months		Total	
	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses
Fixed income securities:						
Municipal bonds	\$ 137	\$ (3)	\$ —	\$ —	\$ 137	\$ (3)
Foreign debt	1,619	(120)	1,961	(315)	3,580	(435)
Corporate debt	4,679	(152)	1,439	(669)	6,118	(821)
Preferred stock	2,038	(77)	8,329	(587)	10,367	(664)
Mortgage-backed securities	31	(3)	—	—	31	(3)
Common stock	1,563	(121)	2,004	(1,025)	3,567	(1,146)
Total temporary impaired securities	<u>\$ 10,067</u>	<u>\$ (476)</u>	<u>\$ 13,733</u>	<u>\$ (2,596)</u>	<u>\$ 23,800</u>	<u>\$ (3,072)</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Our perpetual care trust investment unrealized losses, their associated fair market values, and the duration of unrealized losses as of December 31, 2015 are shown in the following tables (in thousands):

	December 31, 2015					
	In Loss Position Less than 12 months		In Loss Position Greater than 12 months		Total	
	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses	Fair market value	Unrealized Losses
Fixed income securities:						
Municipal bonds	\$ 280	\$ (45)	\$ —	\$ —	\$ 280	\$ (45)
Foreign debt	2,541	(265)	281	(215)	2,822	(480)
Corporate debt	10,463	(2,164)	2,210	(931)	12,673	(3,095)
Preferred stock	7,100	(301)	3,568	(309)	10,668	(610)
Common stock	7,379	(1,220)	2,186	(719)	9,565	(1,939)
Total temporary impaired securities	<u>\$ 27,763</u>	<u>\$ (3,995)</u>	<u>\$ 8,245</u>	<u>\$ (2,174)</u>	<u>\$ 36,008</u>	<u>\$ (6,169)</u>

Perpetual care trust investment security transactions recorded in *Interest expense* on our Consolidated Statements of Operations for the years ended December 31, 2014, 2015 and 2016 were as follows (in thousands):

	Year ended December 31,		
	2014	2015	2016
Realized gains	\$ 3,468	\$ 1,773	\$ 872
Realized losses	(1,748)	(2,431)	(3,069)
Decrease (increase) in Care trusts' corpus	(1,720)	658	2,197
Total	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

Perpetual care trust investment security transactions recorded in *Revenues: Cemetery* for the years ended December 31, 2014, 2015 and 2016 were as follows (in thousands):

	Year ended December 31,		
	2014	2015	2016
Investment income	\$ 4,713	\$ 5,315	\$ 6,451
Realized gains (losses), net	1,112	436	(434)
Total	<u>\$ 5,825</u>	<u>\$ 5,751</u>	<u>\$ 6,017</u>

Purchases and sales of investments in the perpetual care trusts for the years ended December 31, 2014, 2015 and 2016 were as follows (in thousands):

	Year ended December 31,		
	2014	2015	2016
Purchases	\$ (38,413)	\$ (16,694)	\$ (16,546)
Sales	35,402	14,710	16,534

## 11. FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date applicable for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. We disclose the extent to which fair value is used to measure financial assets and liabilities, the inputs utilized in calculating valuation measurements, and the effect of the measurement of significant unobservable inputs on earnings, or changes in net assets, as of the measurement date.

We evaluated our financial assets and liabilities for those financial assets and liabilities that met the criteria of the disclosure requirements and fair value framework. The carrying values of cash and cash equivalents, trade receivables, and trade payables approximate the fair values of those instruments due to the short-term nature of the instruments. The fair values of receivables on preneed funeral and cemetery contracts are impracticable to estimate because of the lack of a trading market and the diverse number of individual contracts with varying terms. Our long-term debt and Credit Facility (as defined in Note 13) are classified within Level 2 of the Fair Value Measurements hierarchy. The fair values of the long-term debt and Credit Facility approximate the carrying values of these instruments based on the index yields of similar securities compared to U.S. Treasury yield curves. The

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

fair value of the Convertible Notes issued in March 2014 was approximately \$194.6 million at December 31, 2016 based on the last traded or broker quoted price. We identified investments in fixed income securities, common stock and mutual funds presented within the preneed and perpetual care trust investments categories on our Consolidated Balance Sheets as having met the criteria for fair value measurement.

The following three-level valuation hierarchy based upon the transparency of inputs is utilized in the measurement and valuation of financial assets or liabilities as of the measurement date:

- Level 1—Fair value of securities based on unadjusted quoted prices for identical assets or liabilities in active markets. Our investments classified as Level 1 securities include cash, common stock and U.S. treasury debt;
- Level 2—Fair value of securities estimated based on quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and inputs other than quoted market prices that are observable or that can be corroborated by observable market data by correlation. These inputs include interest rates, yield curves, credit risk, prepayment speeds, rating and tax-exempt status. Our investments classified as Level 2 securities include state obligations, municipal bonds, corporate debt, preferred stocks, foreign debt, mortgage-backed securities, fixed income mutual funds and other investments.
- Level 3—Unobservable inputs based upon the reporting entity's internally developed assumptions, which market participants would use in pricing the asset or liability. As of December 31, 2015 and 2016, we did not have any assets that had fair values determined by Level 3 inputs and no liabilities measured at fair value.

We account for our investments as available-for-sale and measure them at fair value under standards of financial accounting and reporting for investments in equity instruments that have readily determinable fair values and for all investments in debt securities. See Notes 6 and 10 to our Consolidated Financial Statements herein for the fair value hierarchy levels of our trust investments.

## 12. INTANGIBLE AND OTHER NON-CURRENT ASSETS

Intangible and other non-current assets at December 31, 2015 and 2016 were as follows (in thousands):

	December 31, 2015	December 31, 2016
Prepaid agreements not-to-compete, net of accumulated amortization of \$5,404 and \$5,501, respectively	\$ 1,912	\$ 3,244
Tradenames	8,856	11,663
Other	210	50
Intangible and other non-current assets	<u>\$ 10,978</u>	<u>\$ 14,957</u>

Prepaid agreements not-to-compete are amortized over the term of the respective agreements, ranging generally from one to ten years. Amortization expense was approximately \$349,000, \$300,000 and \$435,000 for the years ended December 31, 2014, 2015 and 2016, respectively. During the year ended December 31, 2016, we increased prepaid agreements not-to-compete by \$1.6 million related to our 2016 acquisitions described in Note 3 to the Consolidated Financial Statements included herein.

Our tradenames have indefinite lives and therefore are not amortized. During the year ended December 31, 2016, we increased tradenames by approximately \$3.0 million related to our 2016 acquisitions described in Note 3 to the Consolidated Financial Statements included herein. We recorded an impairment to tradenames of \$145,000 related to a funeral home business held for sale at September 30, 2016, as the carrying value exceeded its fair value. The impairment was recorded in *Other, net* on our Consolidated Statements of Operations. See Note 1 to the Consolidated Financial Statements included herein, for a discussion of the methodology used for our annual indefinite-lived intangible asset impairment test.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 13. LONG-TERM DEBT

Our long-term debt consisted of the following at December 31, 2015 and 2016 (in thousands):

	December 31, 2015	December 31, 2016
Revolving credit facility, secured, floating rate	\$ 92,600	\$ 67,700
Term loan, secured, floating rate	110,937	138,750
Acquisition debt	4,929	12,245
Debt issuance costs, net of accumulated amortization of \$3,246 and \$4,138, respectively	(1,445)	(1,270)
Less: current portion	(12,012)	(13,021)
Total long-term debt, net of current portion	<u>\$ 195,009</u>	<u>\$ 204,404</u>

As of December 31, 2016, we had a \$300 million secured bank credit facility with Bank of America, N.A. as Administrative Agent (the “Credit Agreement”), comprised of a \$150 million revolving credit facility and a \$150 million term loan, (collectively, the “Credit Facility”). The Credit Facility also contains an accordion provision to borrow up to an additional \$75 million in revolving loans, subject to certain conditions. The Credit Facility matures on February 9, 2021 and is collateralized by all personal property and funeral home real property in certain states.

On February 9, 2016, we entered into a seventh amendment (the “Seventh Amendment”) to our Credit Facility. The Seventh Amendment resulted in, among other things, (i) reducing our LIBOR based variable interest rate 37.5 basis points, (ii) extending the maturity so that the Credit Agreement will mature at the earlier of (a) any date that is 91 days prior to the maturity of any subordinated debt (including the \$143.75 million in principal amount of the Convertible Notes, as defined in Note 12 to the Consolidated Financial Statements included herein) or (b) February 9, 2021, (iii) increasing and funding the term loan so that \$150 million was outstanding upon the effectiveness of the Seventh Amendment, (iv) reducing the size of the revolver to \$150 million, (v) increasing the accordion to \$75 million and (vi) updating the amortization payments for the term loan facility so that the borrowings under the term loan facility are subject to amortization payments of (a) \$2.81 million at the end of each fiscal quarter beginning with the fiscal quarter ending March 31, 2016 through the fiscal quarter ending December 31, 2017, (b) \$3.75 million at the end of each fiscal quarter beginning with the fiscal quarter ending March 31, 2018 through the fiscal quarter ending March 31, 2020 and (c) \$4.69 million at the end of each fiscal quarter beginning with the fiscal quarter ending June 30, 2020 through the fiscal quarter ending December 31, 2020. In connection with the Seventh Amendment, we recognized a loss of \$0.6 million to write-off the related unamortized debt issuance costs.

As of December 31, 2016, we had outstanding borrowings under the revolving credit facility of \$67.7 million and approximately \$138.8 million was outstanding on the term loan. We have one letter of credit issued and outstanding under the Credit Facility at December 31, 2016. The letter of credit was issued on November 30, 2016 for approximately \$2.0 million, bears interest at 2.125% and will expire on November 27, 2017. Outstanding borrowings under the Credit Facility bear interest at either a prime rate or a LIBOR rate, plus an applicable margin based upon the Company’s leverage ratio. As of December 31, 2016, the prime rate margin was equivalent to 1.125% and the LIBOR margin was 2.125%. The weighted average interest rate on the Credit Facility for the year ended December 31, 2016 was 2.8%.

We have no material assets or operations independent of our subsidiaries. All assets and operations are held and conducted by subsidiaries, each of which have fully and unconditionally guaranteed our obligations under the Credit Agreement. Additionally, we do not currently have any significant restrictions on our ability to receive dividends or loans from any subsidiary guarantor under the Credit Agreement.

We were in compliance with the covenants contained in our Credit Agreement as of December 31, 2015 and 2016. The Credit Agreement contains key ratios that we must comply with including a requirement to maintain a leverage ratio of no more than 3.50 to 1.00 and a covenant to maintain a fixed charge coverage ratio of no less than 1.20 to 1.00. As of December 31, 2016, the leverage ratio was 2.92 to 1.00 and the fixed charge coverage ratio was 2.21 to 1.00.

Acquisition debt consists of deferred purchase price and promissory notes payable to sellers. A majority of the deferred purchase price and notes bear interest at 0% and are discounted at imputed interest rates ranging from 7.3% to 10.0%. We have one promissory note that bears interest at a rate of 8.0%. Original maturities range from five to twenty years. The increase in acquisition debt was primarily related to the \$8.9 million of deferred purchase price payments for the funeral home businesses acquired in 2016.

Beginning January 1, 2016, debt issuance costs are retroactively reflected as a direct deduction from the carrying value of the related debt liability (refer herein to Note 1 to the Consolidated Financial Statements). Amortization of debt issuance costs related to our Credit Facility was approximately \$0.5 million and \$0.4 million for the years ended December 31, 2015 and 2016,

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

respectively. Debt issuance costs are being amortized over the term of the related debt using the effective interest method for our term loan and the straight line method for our revolving credit facility.

The aggregate maturities of our long-term debt for the next five years subsequent to December 31, 2016 and thereafter are as follows (in thousands):

### Years ending December 31,

2017	\$	13,021
2018		16,854
2019		16,918
2020		19,042
2021		148,379
2022 and thereafter		4,481
	\$	<u>218,695</u>

## 14. CONVERTIBLE SUBORDINATED NOTES

On March 19, 2014, we issued \$143.75 million aggregate principal amount of 2.75% convertible subordinated notes due March 15, 2021 (the “Convertible Notes”). The Convertible Notes have not been registered under the Securities Act of 1933, as amended (the “Securities Act”), and were offered only to “qualified institutional buyers” in compliance with Rule 144A under the Securities Act. The Convertible Notes are governed by an indenture dated as of March 19, 2014 between Wilmington Trust, National Association, as Trustee, and us (the “Indenture”). The Convertible Notes bear interest at 2.75%. Interest on the Convertible Notes began to accrue on March 19, 2014 and is payable semi-annually in arrears on March 15 and September 15 of each year.

The Convertible Notes are general unsecured obligations and are subordinated in the right of payment to all of our existing and future senior indebtedness and equal in right of payment with our other existing and future subordinated indebtedness. The initial conversion rate of the Convertible Notes was 44.3169 shares of our common stock per \$1,000 principal amount of the Convertible Notes, equivalent to an initial conversion price of approximately \$22.56 per share of common stock. The conversion rate is subject to adjustment upon the occurrence of certain events, as described in the Indenture. During the year ended December 31, 2016, an adjustment to the conversion rate of the Convertible Notes was triggered when our Board increased the dividends declared per common share from \$0.025 per share to \$0.05 per share. At December 31, 2016, the adjusted conversion rate of the Convertible Notes is 44.4108 shares of our common stock per \$1,000 principal amount of Convertible Notes, equivalent to an adjusted conversion price of approximately \$22.52 per share of common stock.

The Convertible Notes mature on March 15, 2021, unless earlier converted or purchased by us. The conversion option of the Convertible Notes is not an embedded derivative. Holders of the Convertible Notes may convert their Convertible Notes at their option at any time prior to December 15, 2020, if certain conditions are met. We may not redeem the Convertible Notes prior to maturity. However, in the event of a fundamental change (as defined in the Indenture), subject to certain conditions, a holder of the Convertible Notes will have the option to require us to purchase all or a portion of its Convertible Notes for cash. The fundamental change purchase price will equal 100% of the principal amount of the Convertible Notes to be purchased, plus any accrued and unpaid interest up to, but excluding, the fundamental change purchase date.

Beginning January 1, 2016, debt issuance costs are retroactively reflected as a direct deduction from the carrying value of the related debt liability (refer herein to Note 1 to the Consolidated Financial Statements). The unamortized discount and the unamortized debt issuance costs are being amortized using the effective interest method over the remaining term of approximately 50 months of the Convertible Notes. The effective interest rate on the unamortized discount and the debt issuance costs for the years ended December 31, 2015 and 2016 was 6.75% and 2.75%, respectively.

Equity issuance costs are included in APIC on our Consolidated Balance Sheets and are not amortized. Additionally, the recognition of the Convertible Notes as two separate components results in a basis difference associated with the liability component which represents a temporary tax difference. As a result, we recognized a deferred tax liability of \$12.7 million related to this temporary difference which was recorded as a reduction to APIC and an increase to our deferred tax liability. The deferred tax liability is being amortized over the seven year term of the Convertible Notes. At December 31, 2016, the balance of our deferred tax liability related to our Convertible Notes was \$8.6 million.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The carrying values of the liability and equity components of the Convertible Notes at December 31, 2015 and 2016 are reflected on our Consolidated Balance Sheets as follows (in thousands):

	<u>December 31, 2015</u>	<u>December 31, 2016</u>
Long-term liabilities:		
Principal amount	\$ 143,750	\$ 143,750
Unamortized discount of liability component	(25,754)	(21,887)
Convertible Notes issuance costs, net of accumulated amortization of \$858 and \$1,359, respectively	(2,769)	(2,268)
Carrying value of the liability component	<u>\$ 115,227</u>	<u>\$ 119,596</u>
Equity component carrying value	<u>\$ 17,973</u>	<u>\$ 17,973</u>

The fair value of the Convertible Notes, which are Level 2 measurements, was approximately \$194.6 million at December 31, 2016.

Interest expense on the Convertible Notes included contractual coupon interest expense of \$4.0 million for both the years ended December 31, 2015 and 2016. Amortization of debt issuance costs related to our Convertible Notes was approximately \$0.5 million for both the years ended December 31, 2015 and 2016. Accretion of the discount on the Convertible Notes was approximately \$3.5 million and \$3.9 million for the years ended December 31, 2015 and 2016, respectively.

The aggregate maturities of our Convertible Notes for the five years subsequent to December 31, 2016 and thereafter are as follows (in thousands):

<b>Years ending December 31,</b>	<u>Principal Maturity</u>	<u>Discount Amortization</u>	<u>Present Value</u>
2017	\$ —	\$ (4,328)	\$ (4,328)
2018	—	(4,844)	(4,844)
2019	—	(5,422)	(5,422)
2020	—	(6,068)	(6,068)
2021	143,750	(1,225)	142,525
	<u>\$ 143,750</u>	<u>\$ (21,887)</u>	<u>\$ 121,863</u>

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**15. COMMITMENTS AND CONTINGENCIES**

*Leases*

We lease certain office facilities, certain funeral homes, vehicles and equipment under operating leases with original terms ranging from one to twelve years. Certain of these leases provide for an annual adjustment and contain options for renewal. Rent expense totaled \$6.4 million, \$6.5 million and \$6.1 million for the years ended December 31, 2014, 2015 and 2016, respectively. Assets acquired under capital leases are included in property, plant and equipment in our accompanying Consolidated Balance Sheets in the amount of \$2.9 million in 2015 and \$2.7 million in 2016, net of accumulated depreciation. Capital lease obligations are included in current and long-term debt as indicated below. At December 31, 2016, future minimum lease payments under non-cancelable lease agreements were as follows (in thousands):

	Future Minimum Lease Payments	
	Operating Leases	Capital Leases
<b>Years ending December 31,</b>		
2017	\$ 4,243	\$ 483
2018	2,660	421
2019	2,380	388
2020	1,840	334
2021	1,446	334
Thereafter	566	2,996
Total future minimum lease payments	<u>\$ 13,135</u>	<u>\$ 4,956</u>
Less: amount representing interest (rates ranging from 7.0% to 10.0%)		(2,080)
Less: current portion of obligations under capital leases		(246)
Long-term obligations under capital leases		<u>\$ 2,630</u>

*Non-Compete, Consulting and Employment Agreements*

We have various non-compete agreements with former owners and employees. These agreements are generally for one to ten years and provide for periodic future payments over the term of the agreements.

We have various consulting agreements with former owners of businesses we have acquired. Payments for such agreements are generally not made in advance. These agreements are generally for one to ten years and provide for bi-weekly or monthly payments.

We have employment agreements with certain of our executive officers and senior leadership. These agreements are generally for three or four years and provide for participation in various incentive compensation arrangements. These agreements automatically renew on an annual basis after their initial term has expired.

At December 31, 2016, the maximum estimated future cash commitments under these agreements with remaining commitment terms, and with original terms of more than one year, are as follows (in thousands):

	Non-Compete	Consulting	Employment	Total
<b>Years ending December 31,</b>				
2017	\$ 2,407	\$ 1,509	\$ 1,720	\$ 5,636
2018	1,326	680	119	2,125
2019	1,111	439	—	1,550
2020	881	301	—	1,182
2021	776	218	—	994
Thereafter	1,576	17	—	1,593
	<u>\$ 8,077</u>	<u>\$ 3,164</u>	<u>\$ 1,839</u>	<u>\$ 13,080</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### 401(K) Plan

We sponsor a defined contribution plan (401K) for the benefit of our employees. Matching contributions and plan administrative expenses totaled \$1.6 million, \$1.7 million and \$1.8 million for 2014, 2015 and 2016, respectively. We do not offer any post-retirement or post-employment benefits.

### Other Commitments

Effective April 30, 2016, we terminated an agreement to outsource the processing of transactions for our cemetery business and certain accounting activities. At that time, all transaction processing returned in-house and we retained most of the personnel of the service provider that resided in our home office. We believe that the costs associated with performing these formerly outsourced activities internally should, for the foreseeable future, be less than the costs we incurred under the outsourcing arrangement. For both years ended December 31, 2014 and 2015, we incurred costs of approximately \$1.9 million, respectively for services rendered under this agreement, of which we paid approximately \$1.0 million, each year, with the remainder paid by the Preneed cemetery trust investments portfolio. For the year ended December 31, 2016, we incurred costs of approximately \$0.9 million for services rendered under this agreement, of which we paid approximately \$0.6 million, with the remainder paid by the Preneed cemetery trust investments portfolio.

### Litigation

We are a party to various litigation matters and proceedings. For each of our outstanding legal matters, we evaluate the merits of the case, our exposure to the matter, possible legal or settlement strategies, and the likelihood of an unfavorable outcome. If we determine that an unfavorable outcome is probable and can be reasonably estimated, we establish the necessary accruals. We hold certain insurance policies that may reduce cash outflows with respect to an adverse outcome of certain of these litigation matters.

## 16. INCOME TAXES

The provision for income taxes from continuing operations for the years ended December 31, 2014, 2015 and 2016 consisted of (in thousands):

	Year Ended December 31,		
	2014	2015	2016
Current:			
U. S. federal provision	\$ 1,188	\$ 9,840	\$ 6,609
State provision	772	862	1,195
Total current provision	\$ 1,960	\$ 10,702	\$ 7,804
Deferred:			
U. S. federal provision	\$ 5,117	\$ 1,928	\$ 3,475
State provision	178	1,107	1,381
Total deferred provision	\$ 5,295	\$ 3,035	\$ 4,856
Total income tax provision	\$ 7,255	\$ 13,737	\$ 12,660

A reconciliation of taxes from continuing operations calculated at the U.S. federal statutory rate to those reflected in the Consolidated Statements of Operations for the years ended December 31, 2014, 2015 and 2016 is as follows (dollars in thousands):

	Year Ended December 31,					
	2014		2015		2016	
	Amount	Percent	Amount	Percent	Amount	Percent
Federal statutory rate	\$ 7,719	34.0 %	\$ 12,105	35.0 %	\$ 11,300	35.0 %
Effect of state income taxes, net of federal benefit	831	3.7	1,618	4.7	1,127	3.5
Effect of non-deductible expenses and other, net	583	2.6	155	0.4	213	0.7
Change in valuation allowance	(138)	(0.6)	(141)	(0.4)	20	0.1
Reduction for tax year 2011 federal audit	(1,740)	(7.7)	—	—	—	—
Total	\$ 7,255	32.0 %	\$ 13,737	39.7 %	\$ 12,660	39.3 %

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

On August 1, 2014, we received notification that the IRS completed its examination of our tax year ended December 31, 2011. As a result, we re-measured our tax liability for unrecognized tax benefits reflecting a reduction to our liability by \$7.3 million. This change resulted in a tax benefit recognized in the amount of \$1.7 million which reduced our effective tax rate for the year ended December 31, 2015. The remainder of the re-measurement resulted in an increase to *Deferred tax liability* in the amount of \$5.6 million. Additionally, we recognized a credit to interest expense of \$0.6 million related to the settled portion of the uncertain tax position.

On August 15, 2016, we settled an open examination with the California Franchise Tax Board. As a result of paying the final assessment, we re-measured our tax liability for unrecognized tax benefits reflecting a reduction to our liability of \$0.2 million. On August 29, 2016, we received notification that the IRS completed its examination of our tax year ended December 31, 2013. As a result, we re-measured our tax liability for unrecognized tax benefits reflecting a reduction to our liability of \$0.6 million, which resulted in an increase to *Deferred tax liability* in the amount of \$0.6 million.

The following table summarizes our unrecognized tax benefit as of December 31, 2015 and 2016 (in thousands):

	December 31, 2015	December 31, 2016
Unrecognized tax benefit	\$ 814	\$ —
Interest accrued on unrecognized tax benefits	\$ 44	\$ —

The tax effects of temporary differences from total operations that give rise to significant deferred tax assets and liabilities at December 31, 2015 and 2016 were as follows (in thousands):

	Year Ended December 31,	
	2015	2016
Deferred income tax assets:		
Net operating loss carryforwards	\$ 2,132	\$ 1,947
Tax credit carryforwards	133	135
State bonus depreciation	993	373
Accrued liabilities and other	9,949	11,163
Amortization of non-compete agreements	897	1,433
Preneed liabilities, net	10,324	9,315
Total deferred income tax assets	24,428	24,366
Less valuation allowance	(189)	(209)
Total deferred income tax assets	\$ 24,239	\$ 24,157
Deferred income tax liabilities:		
Amortization and depreciation	\$ (48,318)	\$ (55,461)
Convertible subordinated notes due 2021	(10,184)	(8,636)
Prepays and other	(1,436)	(615)
Total deferred income tax liabilities	(59,938)	(64,712)
Total net deferred tax liabilities	\$ (35,699)	\$ (40,555)
Current deferred tax asset	\$ 4,257	\$ —
Non-current deferred tax liabilities	(39,956)	(40,555)
Total net deferred tax liabilities	\$ (35,699)	\$ (40,555)

Beginning January 1, 2016, we adopted the FASB's guidance on Balance Sheet Classification of Deferred Taxes, which simplifies deferred tax reporting on the balance sheet and requires all deferred tax assets and liabilities, along with related valuation allowances will be classified as non-current on the balance sheet. The guidance was applied prospectively and all deferred tax assets and liabilities, along with our valuation allowance are now classified as non-current at December 31, 2016.

At December 31, 2015, our current deferred tax asset is included in *Other current assets* and the non-current deferred tax liability is disclosed on a separate line item on our Consolidated Balance Sheets. At December 31, 2016, our total net deferred tax liability is disclosed as a separate line item on our Consolidated Balance Sheets and is classified as a non-current liability.

We record a valuation allowance to reflect the estimated amount of deferred tax assets for which realization is uncertain. Management reviews the valuation allowance at the end of each quarter and makes adjustments if it is determined that it is more likely than not that the tax benefits will be realized. We recognized a net increase of approximately \$20,000 in our valuation allowance during 2016.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

For federal income tax reporting purposes, we have no net operating loss carryforwards. For state reporting purposes, we have approximately \$43.2 million of net operating loss carryforwards that will expire between 2017 and 2036, if not utilized. Based on management's assessment of the various state net operating losses, it was determined that it is more likely than not that we will be able to realize tax benefits on some portion of the amount of the state losses. The valuation allowance at December 31, 2016 was attributable to the deferred tax asset related to a portion of the state operating losses.

We analyze tax benefits for uncertain tax positions and how they are to be recognized, measured, and derecognized in financial statements; provide certain disclosures of uncertain tax matters; and specify how reserves for uncertain tax positions should be classified on the Consolidated Balance Sheets. During 2016, the re-measurement of the tax liability for unrecognized tax benefits arising from the finalization of our IRS and California Franchise Tax Board exams, resulted in an \$0.8 million reduction to our liability related to uncertain tax positions.

We do not have any unrecognized tax benefits recorded as of December 31, 2016 and we do not anticipate a material change in our unrecognized tax benefits during the next twelve months.

A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in thousands):

	Year Ended December 31,		
	2014	2015	2016
Unrecognized tax benefit at beginning of year	\$ 7,832	\$ 515	\$ 814
Reductions based on tax positions related to the prior year	—	—	(17)
Reductions for tax year 2011 federal audit	(7,310)	—	(568)
Additions (reductions) based on tax positions related to the current year	—	299	(229)
Reductions as a result of a lapse of the applicable statute of limitations	(7)	—	—
Unrecognized tax benefit at end of year	<u>\$ 515</u>	<u>\$ 814</u>	<u>\$ —</u>

Our federal income tax returns for 2014 and 2015 are open tax years that may be examined by the IRS.

## 17. STOCKHOLDERS' EQUITY

### *Share Authorization*

We are authorized to issue 80,000,000 shares of common stock, \$0.01 per share par value. We had 22,490,855 and 22,497,873 shares issued and outstanding, net of 5,849,316 shares held in treasury at par, at December 31, 2016 and 2015, respectively.

### *Stock Based Compensation Plans*

All stock-based plans are administered by the Compensation Committee appointed by our Board of Directors (the "Board"). At December 31, 2016, we had one stock benefit plan in effect, the Second Amended and Restated 2006 Long-Term Incentive Plan (the "Amended and Restated 2006 Plan"), under which restricted stock, stock options and performance awards have been granted or remain outstanding. The Amended and Restated 2006 Plan expires on May 24, 2022. The expiration and termination of these plans does not affect the options previously issued and outstanding.

The status of the Amended and Restated 2006 Plan at December 31, 2016 is as follows (shares in thousands):

	Shares Reserved	Shares Available to Issue	Options Outstanding
Amended and Restated 2006 Plan	<u>5,000</u>	<u>1,126</u>	<u>1,650</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### Stock Options

Employee stock options have historically been granted annually, as approved by the Compensation Committee of the Board. The options are granted with an exercise price equal to the closing price of our common stock on the date of grant. All of the options granted under this plan have either five, seven or ten-year terms. We utilize the Black-Scholes option valuation model for estimating the fair value of our stock options. This model allows the use of a range of assumptions related to volatility, risk-free interest rate, expected holding period and dividend yield. The expected volatility utilized in the valuation model is based on the historical volatility of our stock price. The dividend yield and expected holding period are based on historical experience and management's estimate of future events. The risk-free interest rate is derived from the U.S. Treasury yield curve based on the expected life of the option in effect at the time of grant. The fair values of our stock options were calculated using the following weighted average of assumptions, based on the methods described above for the years ended December 31, 2014, 2015 and 2016:

	2014	2015	2016
Dividend yield	0.50%	0.44%	0.50%
Expected volatility	33.34%	32.62%	31.21%
Risk-free interest rate	0.99%	1.13%	1.23%
Expected holding period (years)	3.7	3.6	5.0

During the first quarter of 2016, we granted 235,500 options to certain officers and key employees at an option price of \$20.06. These options will vest in one-fifth increments over a five year period and have a ten year term. The fair value of these stock options is approximately \$1.3 million. During the third quarter of 2016, we canceled 146,100 options related to the retirement of a former executive. In 2015, a total of 628,000 stock options were awarded, the fair value of which is approximately \$3.7 million. In 2014, a total of 803,700 stock options were awarded, the fair value of which is approximately \$4.1 million.

A summary of the stock options at December 31, 2014, 2015 and 2016 and changes during the three years ended December 31, 2016 is presented in the table and narrative below (shares in thousands):

	Year Ended December 31,					
	2014		2015		2016	
	Shares	Wtd. Avg. Ex. Price	Shares	Wtd. Avg. Ex. Price	Shares	Wtd. Avg. Ex. Price
Outstanding at beginning of period	766	\$ 13.03	1,381	\$ 17.07	1,695	\$ 18.95
Adjustment to beginning balance	—	\$ —	—	\$ —	18	\$ 18.94
Granted	804	\$ 20.20	653	\$ 22.66	236	\$ 20.06
Exercised	(68)	\$ 5.47	(110)	\$ 14.36	(112)	\$ 13.76
Canceled or expired	(121)	\$ 18.80	(229)	\$ 20.39	(187)	\$ 21.30
Outstanding at end of year	1,381	\$ 17.07	1,695	\$ 18.95	1,650	\$ 19.18
Exercisable at end of year	329	\$ 10.97	583	\$ 15.00	1,106	\$ 18.21

The aggregate intrinsic value of the outstanding and exercisable stock options at December 31, 2016 was \$15.6 million and \$11.5 million, respectively. The total intrinsic value of options exercised during 2014, 2015 and 2016 totaled \$1.0 million, \$1.1 million and \$1.2 million, respectively.

The total fair value of stock options vested during 2014, 2015 and 2016 totaled approximately \$0.8 million, \$1.8 million and \$2.8 million, respectively. We recorded pre-tax stock-based compensation expense for stock options totaling approximately \$1.6 million, \$2.4 million and \$1.7 million in 2014, 2015 and 2016, respectively. The significant decrease in expense for the year ended December 31, 2016 as compared to 2015 was due to the cancellation of options for the retirement of a former executive which resulted in a decrease of approximately \$0.2 million and the full vesting of a grant in the second quarter of 2016 resulting in a decrease of approximately \$0.3 million.

As of December 31, 2016, there was \$1.5 million of unrecognized compensation cost, net of estimated forfeitures, related to unvested stock options expected to be recognized over a weighted average period of approximately two years.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table further describes our outstanding stock options at December 31, 2016:

Actual Ranges of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding at 12/31/16	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable at 12/31/16	Weighted-Average Exercise Price
\$4.78 - \$5.94	105,603	4.50	\$ 5.66	105,603	\$ 5.66
\$16.73 - \$20.06	569,400	5.30	\$ 17.84	380,000	\$ 16.73
\$20.26 - \$22.58	974,943	3.60	\$ 21.43	620,877	\$ 21.26
\$4.78 - \$22.58	1,649,946	4.89	\$ 19.18	1,106,480	\$ 18.21

### *Employee Stock Purchase Plan*

We provide all employees the opportunity to purchase common stock through payroll deductions in our employee stock purchase plan ("ESPP"). Purchases are made quarterly; the price being 85% of the lower of the price on the first day of the plan entry date (beginning of a quarter) or the actual date of purchase (end of quarter). In 2016, employees purchased a total of 44,774 shares at a weighted average price of \$19.48 per share. In 2015, employees purchased a total of 44,074 shares at a weighted average price of \$17.17 per share. In 2014, employees purchased a total of 55,877 shares at a weighted average price of \$15.50 per share. Pre-tax compensation expense for the ESPP totaling approximately \$260,000, \$197,000, and \$234,000 was expensed in 2014, 2015 and 2016, respectively.

The fair values of the right (option) to purchase shares under the ESPP are estimated at the date of purchase with the four quarterly purchase dates using the following assumptions:

	2014	2015	2016
Dividend yield	0.6%	0.4%	0.6%
Expected volatility	33%	24%	25%
Risk-free interest rate	0.07%, 0.09%, 0.11%, 0.13%	0.02%, 0.11%, 0.18%, 0.25%	0.22%, 0.49%, 0.55%, 0.61%
Expected life (years)	.25, .50, .75, 1.00	.25, .50, .75, 1.00	.25, .50, .75, 1.00

Expected volatilities are based on the historical volatility during the previous twelve months of the underlying common stock. The risk-free rate for the quarterly purchase periods is based on the U.S. Treasury yields in effect at the time of purchase. The expected life of the ESPP grants represents the calendar quarters from the beginning of the year to the purchase date (end of each quarter).

### *Restricted Stock*

From time to time, we issue shares of restricted stock to certain officers, key employees and directors of the Company from our Amended and Restated 2006 Plan. The restricted stock issued to officers and key employees vest in either 25% or 33.33% increments over four or three year terms, respectively. During the first quarter of 2016, we issued restricted stock totaling 16,900 to certain employees that vest over a three year period and had an aggregate grant date market value of approximately \$0.3 million. A summary of the status of unvested restricted stock as of December 31, 2016, and changes during 2016, is presented below (shares in thousands):

<u>Unvested stock awards</u>	Shares	Weighted Average Grant Date Fair Value
Unvested at January 1, 2016	202	\$ 20.64
Awards	18	20.27
Vestings	(66)	20.78
Cancellations	(91)	20.17
Unvested at December 31, 2016	63	\$ 21.07

Related to the vesting of restricted stock awards previously awarded to our officers and key employees, we recorded pre-tax compensation expense, which is included in general, administrative and other expenses, totaling \$1.8 million for the year ended December 31, 2014, \$1.5 million for the year ended December 31, 2015 and \$0.7 million for the year ended December 31, 2016. The significant decrease in expense for the year ended December 31, 2016 as compared to 2015 was due to the cancellation of 50,000 unvested restricted stock for a former executive.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

As of December 31, 2016, we had \$1.1 million of total unrecognized compensation costs related to unvested restricted stock awards, which are expected to be recognized over a weighted average period of approximately 1.4 years.

### *Performance Awards*

During the first quarter of 2016, we granted 73,700 performance awards to certain officers and key employees, payable in shares. These awards will vest (if at all) on December 31, 2020 provided that certain criteria surrounding Adjusted Consolidated EBITDA (Adjusted Consolidated Earnings Before Interest Tax Depreciation and Amortization) and Relative Shareholder Return performance is achieved and the individual has remained continuously employed by Carriage through such date. The Adjusted Consolidated EBITDA performance represents 25% of the award and the Relative Shareholder Return performance represents 75% of the award. The fair value of these performance awards granted during the first quarter of 2016 was approximately \$1.6 million. The pre-tax compensation expense associated with these awards for the year ended December 31, 2016 was approximately 221,000. During the third quarter of 2016, we canceled 14,200 performance awards related to the retirement of a former executive.

The fair value of the performance awards are estimated on the date of the grant using a Monte-Carlo simulation pricing model with the following assumptions:

	<b>February 23, 2016</b>
	<b>January 1, 2016 - December 31, 2020</b>
Performance period	
Simulation period (years)	4.86
Share price at grant date	\$20.06
Expected volatility	31.2%
Risk-free interest rate	1.21%
Forfeiture rate	2.0%

### *Director Compensation Plans*

On May 17, 2016, our Board approved a new Director Compensation Policy, which provides for the following: (i) each independent director is entitled to an annual retainer of \$75,000, payable in quarterly installments of \$18,750 each at the end of the quarter; and (ii) the Lead Director and chairman of our Audit Committee are entitled to an additional annual retainer of \$10,000, payable in quarterly installments of \$2,500 each at the end of each quarter, and the chairman of our Corporate Governance and Compensation Committees are entitled to an additional annual retainer of \$5,000, payable in quarterly installments of \$1,250 each at the end of each quarter. Any new independent director will receive upon admission to the Board a grant of \$25,000 (in addition to the independent director annual retainer prorated at the time the new director is admitted to the Board) which can be taken in cash or restricted shares of our common stock. The number of shares of such common stock will be determined by dividing the cash amount by the closing price of our common stock on the date of grant, which will be the date of admission to the Board. Such common stock, will vest (based on continued service on the Board) 50% immediately and 25% on the first and second anniversaries of admission. Prior to the approval of the new Director Compensation Policy, there was one meeting during the second quarter of 2016 for which the directors were paid under the previous policy.

On August 9, 2016, Richard W. Scott resigned from our Board. At the time of his resignation, Mr. Scott was serving as the chairman of the Corporate Governance Committee and a member of the Audit and Compensation Committees. On the same day, the Board voted James R. Schenck to serve as a Class 1 Director until the 2018 annual meeting of shareholders. Mr. Schenck was appointed to serve as the chairman of the Corporate Governance Committee and a member of the Audit and Compensation Committees. Concurrently with the appointment, the Board granted Mr. Schenck 1,061 shares of the Company's common stock under our Director Compensation Policy, which such grant was valued at approximately \$25,000 based on the closing price on the grant date. One-half of these shares vested immediately upon grant, and the remaining one-half of the shares will vest equally on August 9, 2017 and August 9, 2018.

We recorded approximately \$0.8 million, \$0.7 million and \$0.4 million of pre-tax compensation expense, which is included in general, administrative and other expenses, in the years ended 2014, 2015 and 2016, respectively, related to the director fees and annual retainers.

### *Cash Dividends*

Our Board declared two quarterly dividends of \$0.025 per share and two quarterly dividends of \$0.05 per share, totaling approximately \$2.5 million. The two dividends of \$0.025 per share were paid on March 1, 2016 and June 1, 2016 and the two dividends of \$0.05 per share were paid on September 1, 2016 and December 1, 2016. During 2015, we paid four quarterly dividends of \$0.025 per share, totaling approximately \$1.8 million.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

### *Accumulated other comprehensive income*

Our components of Accumulated other comprehensive income are as follows (in thousands):

	Accumulated Other Comprehensive Income
Balance at December 31, 2015	\$ —
Decrease in net unrealized gains associated with available-for-sale securities of the trusts	(563)
Reclassification of net unrealized gain activity attributable to the <i>Deferred preneed funeral and cemetery receipts held in trust and Care trusts' corpus</i>	563
Balance at December 31, 2016	<u>\$ —</u>

### 18. SHARE REPURCHASE PROGRAM

On February 25, 2016, our Board approved a share repurchase program authorizing us to purchase up to an aggregate of \$25.0 million of our common stock in accordance with Rule 10b-18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The shares may be purchased from time to time in the open market or in privately negotiated transactions. Purchases will be at times and in amounts as management deems appropriate based on factors such as market conditions, legal requirements and other business considerations. During the year ended December 31, 2016, we did not repurchase any shares of common stock pursuant to this share repurchase program.

During 2015, we purchased 1,927,665 shares of our common stock for a total cost of \$45.0 million, at an average cost of \$23.34 per share under a previous share repurchase program.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 19. EARNINGS PER SHARE

Share-based awards that contain non-forfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are participating securities and included in the computation of both basic and diluted earnings per share. Our grants of restricted stock awards to our employees and directors are considered participating securities and we have prepared our earnings per share calculations to exclude outstanding unvested restricted stock awards, using the two-class method, in the basic and diluted weighted average shares outstanding calculation.

The following table sets forth the computation of the basic and diluted earnings per share for the years ended December 31, 2014, 2015 and 2016:

	Year Ended December 31,		
	2014	2015	2016
	(in thousands, except per share data)		
<b>Numerator for basic earnings per share:</b>			
Numerator from continuing operations			
Income from continuing operations	\$ 15,446	\$ 20,853	\$ 19,581
Less: Earnings allocated to unvested restricted stock	(295)	(257)	(89)
Income attributable to continuing operations	<u>\$ 15,151</u>	<u>\$ 20,596</u>	<u>\$ 19,492</u>
Numerator from discontinued operations			
Income from discontinued operations	\$ 392	\$ —	\$ —
Less: Earnings allocated to unvested restricted stock	(8)	—	—
Income attributable to discontinued operations	<u>\$ 384</u>	<u>\$ —</u>	<u>\$ —</u>
<b>Numerator for diluted earnings per share:</b>			
Income attributable to continuing operations	\$ 15,151	\$ 20,596	\$ 19,492
Income attributable to discontinuing operations	\$ 384	\$ —	\$ —
<b>Denominator</b>			
Denominator for basic earnings per common share - weighted average shares outstanding	18,108	17,791	16,515
Effect of dilutive securities:			
Stock options	149	246	454
Convertible subordinated notes	—	276	491
Denominator for diluted earnings per common share - weighted average shares outstanding	<u>18,257</u>	<u>18,313</u>	<u>17,460</u>
Basic earnings per common share:			
Continuing operations	\$ 0.84	\$ 1.16	\$ 1.18
Discontinued operations	0.02	—	—
Basic earnings per common share	<u>\$ 0.86</u>	<u>\$ 1.16</u>	<u>\$ 1.18</u>
Diluted earnings per common share:			
Continuing operations	\$ 0.83	\$ 1.12	\$ 1.12
Discontinued operations	0.02	—	—
Diluted earnings per common share	<u>\$ 0.85</u>	<u>\$ 1.12</u>	<u>\$ 1.12</u>

The fully diluted weighted average shares outstanding for the years ended December 31, 2015 and 2016, and the corresponding calculation of fully diluted earnings per share, included approximately 0.3 million and 0.5 million shares that would have been issued upon the conversion of our convertible subordinated notes as a result of the application of the if-converted method prescribed by the FASB ASC 260. There were no shares that would have been issued upon conversion under the if-converted method for our convertible subordinated notes for the year ended December 31, 2014.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

There were no options excluded in the computation of diluted earnings per share for the years ended December 31, 2014, 2015 and 2016.

### 20. MAJOR SEGMENTS OF BUSINESS

We conduct funeral and cemetery operations only in the United States. The following table presents revenues from continuing operations, income (loss) from continuing operations before income taxes, total assets, long-lived assets, depreciation and amortization, capital expenditures, number of operating locations, interest expense and income tax expense (benefit) by segment:

	Funeral	Cemetery	Corporate	Consolidated
	(in thousands, except number of operating locations)			
Revenues from continuing operations:				
2016	\$ 189,401	\$ 58,799	\$ —	\$ 248,200
2015	185,818	56,684	—	242,502
2014	173,735	52,389	—	226,124
Income (loss) from continuing operations before income taxes:				
2016	\$ 61,163	\$ 18,400	\$ (47,322)	\$ 32,241
2015	58,404	17,492	(41,306)	34,590
2014	53,385	15,180	(45,864)	22,701
Total assets:				
2016	\$ 634,145	\$ 241,621	\$ 9,303	\$ 885,069
2015	591,389	229,479	12,271	833,139
2014	568,842	240,009	18,677	827,528
Long-lived assets:				
2016	\$ 509,361	\$ 89,767	\$ 2,548	\$ 601,676
2015	472,419	89,866	3,370	565,655
2014	437,735	88,467	1,835	528,037
Depreciation and amortization				
2016	\$ 8,891	\$ 5,028	\$ 1,502	\$ 15,421
2015	7,614	4,420	1,746	13,780
2014	6,841	3,704	1,378	11,923
Capital expenditures:				
2016	\$ 17,411	\$ 4,962	\$ 731	\$ 23,104
2015	27,654	5,332	2,838	35,824
2014	16,804	5,606	1,265	23,675
Number of operating locations at year end:				
2016	170	32	—	202
2015	167	32	—	199
2014	164	32	—	196
Interest expense:				
2016	\$ 826	\$ 3	\$ 10,909	\$ 11,738
2015	577	8	9,974	10,559
2014	316	17	9,975	10,308
Income tax expense (benefit)				
2016	\$ 24,019	\$ 7,226	\$ (18,585)	\$ 12,660
2015	23,195	6,947	(16,405)	13,737
2014	17,061	4,851	(14,657)	7,255

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**21. SUPPLEMENTARY DATA**

***Balance Sheet***

The detail of certain balance sheet accounts as of December 31, 2015 and 2016 is as follows (in thousands):

	<b>December 31,</b>	
	<b>2015</b>	<b>2016</b>
Other current assets:		
Deferred taxes	\$ 4,256	\$ —
Income tax receivables	279	1,932
Other current assets	172	102
Total other current assets	<u>\$ 4,707</u>	<u>\$ 2,034</u>
Current portion of long-term debt and capital lease obligations		
Term note	\$ 10,938	\$ 11,250
Acquisition debt	\$ 1,075	\$ 1,771
Capital leases	\$ 223	\$ 246
Total current portion of long-term debt and capital lease obligations	<u>\$ 12,236</u>	<u>\$ 13,267</u>
Other current liabilities:		
Income taxes payable	\$ 387	\$ 509
Deferred rent	137	208
Total other current liabilities	<u>\$ 524</u>	<u>\$ 717</u>
Accrued liabilities:		
Accrued salaries and wages	\$ 2,383	\$ 4,005
Accrued incentive compensation	5,862	8,237
Accrued vacation	2,239	2,305
Accrued insurance	2,246	1,726
Accrued interest	1,295	1,235
Accrued ad valorem and franchise taxes	604	981
Accrued commissions	470	543
Other accrued liabilities	1,442	1,059
Total accrued liabilities	<u>\$ 16,541</u>	<u>\$ 20,091</u>
Other long term liabilities:		
Deferred rent	\$ 1,405	\$ 1,207
Incentive compensation	2,505	575
Reserve for uncertain tax positions	814	—
Contingent consideration	763	785
Other long term liabilities	44	—
Total other long term liabilities	<u>\$ 5,531</u>	<u>\$ 2,567</u>



# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## Revenues and Field costs and expenses

The detail of certain income statement accounts for the years ended December 31, 2014, 2015 and 2016 is as follows (in thousands):

	Year Ended December 31,		
	2014	2015	2016
Revenues:			
Goods			
Funeral	\$ 66,877	\$ 71,399	\$ 72,002
Cemetery	32,300	35,479	37,678
Total goods	\$ 99,177	\$ 106,878	\$ 109,680
Services			
Funeral	\$ 97,375	\$ 104,969	\$ 108,622
Cemetery	10,556	11,178	11,269
Total services	\$ 107,931	\$ 116,147	\$ 119,891
Financial revenue			
Preneed funeral commission income	\$ 2,036	\$ 1,484	\$ 1,429
Preneed funeral trust earnings	7,447	7,966	7,348
Cemetery trust earnings	8,123	8,440	8,004
Cemetery finance charges	1,410	1,587	1,848
Total financial revenue	\$ 19,016	\$ 19,477	\$ 18,629
Total revenues	\$ 226,124	\$ 242,502	\$ 248,200
Field costs and expenses:			
Goods			
Funeral	\$ 54,421	\$ 56,819	\$ 56,787
Cemetery	23,800	24,600	26,199
Total goods	\$ 78,221	\$ 81,419	\$ 82,986
Services			
Funeral	\$ 49,357	\$ 51,236	\$ 52,595
Cemetery	6,860	6,924	7,081
Total services	\$ 56,217	\$ 58,160	\$ 59,676
Financial expenses			
Preneed funeral commissions	\$ 1,078	\$ 1,031	\$ 747
Trust administration fees	249	353	378
Total financial expenses	\$ 1,327	\$ 1,384	\$ 1,125
Total field costs and expenses	\$ 135,765	\$ 140,963	\$ 143,787

The Field costs and expenses, for purposes of this supplemental disclosure, include only costs and expenses that are directly allocable between the goods, services and financial categories in the funeral and cemetery segments. Depreciation and amortization and Regional and unallocated funeral and cemetery costs are not included in this disclosure.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## 22. QUARTERLY FINANCIAL DATA (UNAUDITED)

The tables below set forth consolidated operating results by fiscal quarter for the years ended December 31, 2015 and 2016 (in thousands, except earnings per share):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
<b>2016</b>				
Revenues	\$ 63,331	\$ 61,865	\$ 60,140	\$ 62,864
Gross profit	21,303	18,807	18,228	21,312
Net income	<u>\$ 4,571</u>	<u>\$ 5,200</u>	<u>\$ 5,683</u>	<u>\$ 4,127</u>
Basic earnings per common share: (a)	\$ 0.27	\$ 0.31	\$ 0.34	\$ 0.25
Diluted earnings per common share: (a)	\$ 0.27	\$ 0.30	\$ 0.33	\$ 0.22
<b>2015</b>				
Revenues	\$ 63,253	\$ 59,261	\$ 58,378	\$ 61,610
Gross profit	22,209	18,248	17,360	19,691
Net income	<u>\$ 6,418</u>	<u>\$ 4,557</u>	<u>\$ 4,444</u>	<u>\$ 5,434</u>
Basic earnings per common share: (a)	\$ 0.35	\$ 0.25	\$ 0.25	\$ 0.32
Diluted earnings per common share: (a)	\$ 0.34	\$ 0.24	\$ 0.24	\$ 0.31

(a) Earnings per share are computed independently for each of the quarters presented. Therefore, the sum of the quarterly per share amounts may not equal the total computed for 2015 and 2016 due to rounding.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)**

**23. SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION**

The following information is supplemental disclosure for the Consolidated Statements of Cash Flows (in thousands):

	<b>Year Ended December 31,</b>		
	<b>2014</b>	<b>2015</b>	<b>2016</b>
Cash paid for interest and financing costs	\$ 8,894	\$ 9,159	\$ 10,366
Cash paid for taxes	2,674	8,283	10,874
Fair value of stock, stock options and performance awards issued to directors, officers, and certain other employees	8,219	4,879	3,275
Restricted common stock withheld for payroll taxes	1,305	1,580	580
Net withdrawals (deposits) from / into preneed funeral trusts	(418)	12,054	(3,687)
Net withdrawals (deposits) from / into preneed cemetery trusts	1	8,681	(6,405)
Net withdrawals (deposits) from / into perpetual care trusts	1,857	5,543	(3,762)
Net increase in preneed receivables	(1,731)	(1,714)	(2,385)
Net deposits of receivables into preneed trusts	(1,643)	(735)	(674)
Net change in preneed funeral receivables increasing deferred revenue	677	483	1,450
Net change in preneed cemetery receivables decreasing deferred revenue	(374)	(154)	(2,090)
Net (withdrawals) deposits from / into preneed funeral trust accounts (decreasing) increasing deferred preneed funeral receipts held in trust	418	(12,054)	3,687
Net (withdrawals) deposits from / into preneed cemetery trust accounts (decreasing) increasing deferred cemetery receipts held in trust	(1)	(8,681)	6,405
Net (withdrawals) deposits from / into perpetual care trust accounts (decreasing) increasing care trusts' corpus	(1,901)	(5,726)	3,874

**CARRIAGE SERVICES, INC.**  
**SCHEDULE II — VALUATION AND QUALIFYING ACCOUNTS**  
(in thousands)

<u>Description</u>	<u>Balance at beginning of year</u>	<u>Charged to costs and expenses</u>	<u>Deduction</u>	<u>Balance at end of year</u>
<b>Year ended December 31, 2014:</b>				
Allowance for bad debts, current portion	\$ 847	\$ 1,705	\$ 1,425	\$ 1,127
Allowance for receivables from preneed funeral and cemetery trusts and contract cancellations, non-current portion	\$ 1,825	\$ 1,284	\$ 770	\$ 2,339
Employee severance accruals	\$ 249	\$ 681	\$ 714	\$ 216
Litigation reserves	\$ 17	\$ —	\$ 14	\$ 3
Valuation allowance of the deferred tax asset	\$ 468	\$ —	\$ 138	\$ 330
<b>Year ended December 31, 2015:</b>				
Allowance for bad debts, current portion	\$ 1,127	\$ 966	\$ 1,039	\$ 1,054
Allowance for receivables from preneed funeral and cemetery trusts and contract cancellations, non-current portion	\$ 2,339	\$ 712	\$ 1,009	\$ 2,042
Employee severance accruals	\$ 216	\$ 698	\$ 634	\$ 280
Litigation reserves	\$ 3	\$ —	\$ 3	\$ —
Valuation allowance of the deferred tax asset	\$ 330	\$ —	\$ 141	\$ 189
<b>Year ended December 31, 2016:</b>				
Allowance for bad debts, current portion	\$ 1,054	\$ 1,155	\$ 1,138	\$ 1,071
Allowance for receivables from preneed funeral and cemetery trusts and contract cancellations, non-current portion	\$ 2,042	\$ 943	\$ 819	\$ 2,166
Employee severance accruals	\$ 280	\$ 3,641	\$ 2,404	\$ 1,517
Valuation allowance of the deferred tax asset	\$ 189	\$ 20	\$ —	\$ 209

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

None.

**ITEM 9A. CONTROLS AND PROCEDURES.**

***Management's Evaluation of Disclosure Controls and Procedures***

Our management, including our principal executive and financial officers, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Exchange Act) as of the end of the period covered by this Form 10-K. Our disclosure controls and procedures are designed to ensure that the information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and to ensure that such information is accumulated and communicated to management, including our principal executive and financial officers, as appropriate, to allow timely decisions regarding required disclosure. Based on such evaluation, our principal executive and financial officers have concluded that our disclosure controls and procedures were effective, as of December 31, 2016 (the end of the period covered by this Annual Report on Form 10-K).

***Management's Annual Report on Internal Control over Financial Reporting***

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Management's report on our internal control over financial reporting is presented on the following page of this Form 10-K. Grant Thornton LLP, the independent registered public accounting firm that audited the financial statements included in this Form 10-K, has issued an attestation report on our internal control over financial reporting.

## **MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined under Rule 13a-15(f) promulgated under the Securities Exchange Act of 1934, as amended.

Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's Consolidated Financial Statements for external purposes in accordance with generally accepted accounting principles, and includes those policies and procedures that:

- (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;
- (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the U.S., and that our receipts and expenditures are being made only in accordance with authorizations of management and our directors; and
- (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our Consolidated Financial Statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an assessment of the Company's internal control over financial reporting as of December 31, 2016 using the framework specified in *Internal Control — Integrated Framework (2013)*, published by the Committee of Sponsoring Organizations of the Treadway Commission. Based on such assessment, management has concluded that the Company's internal control over financial reporting was effective as of December 31, 2016.

The Company's internal control over financial reporting as of December 31, 2016 has been audited by Grant Thornton LLP, an independent registered public accounting firm, which also audited the financial statements of the Company for the year ended December 31, 2016, as stated in their report which is presented in this Annual Report.

/s/ Melvin C. Payne

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Melvin C. Payne

Chief Executive Officer and Chairman of the Board

/s/ Viki K. Blinderman

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Viki K. Blinderman

Senior Vice President, Principal Financial Officer, Chief Accounting Officer and Secretary

February 23, 2017



### **Changes in Internal Control Over Financial Reporting**

During the three months ended December 31, 2016, there was no change in our system of internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

### **ITEM 9B. OTHER INFORMATION.**

None.

## **PART III**

### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.**

#### **Code of Ethics**

We have adopted a Business Ethics and Code of Conduct (the “Code”), which is applicable to our principal executive officer and other senior financial officers, who include our principal financial officer, principal accounting officer or controller, and persons performing similar functions. The Code is available on our internet website at [www.carriageservices.com](http://www.carriageservices.com). To the extent required by SEC rules, we intend to disclose any amendments to this code and any waiver of a provision of the Code for the benefit of our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, on our website within four business days following any such amendment of waiver, or within any other period that may be required under SEC rules from time to time.

The information required by Item 10 is incorporated by reference to the registrant’s definitive proxy statement relating to its 2017 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

### **ITEM 11. EXECUTIVE COMPENSATION.**

The information required by Item 11 is incorporated by reference to the registrant’s definitive proxy statement relating to its 2017 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.**

The information required by Item 12 is incorporated by reference to the registrant’s definitive proxy statement relating to its 2017 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

The following table, required by Item 201(d) of Regulation S-K, summarizes information regarding the number of shares of our common stock that are available for issuance under all of our existing equity compensation plans as of December 31, 2016.

<u>Plan Category</u>	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,649,946	\$ 19.18	1,125,765
Equity compensation plans not approved by security holders	—	—	—
Total	1,649,946	\$ 19.18	1,125,765

### **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE.**

The information required by Item 13 is incorporated by reference to the registrant’s definitive proxy statement relating to its 2017 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

## ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

The information required by Item 14 is incorporated by reference to the registrant's definitive proxy statement relating to its 2017 annual meeting of stockholders, which proxy statement will be filed pursuant to Regulation 14A of the Exchange Act within 120 days after the end of the last fiscal year.

## PART IV

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

### (1) FINANCIAL STATEMENTS

The following financial statements and the Report of Independent Registered Public Accounting Firm are filed as a part of this Form 10-K on the pages indicated:

	<u>Page</u>
<u>Reports of Independent Registered Public Accounting Firm</u>	<u>49</u>
<u>Consolidated Balance Sheets as of December 31, 2015 and 2016</u>	<u>51</u>
<u>Consolidated Statements of Operations for the Years Ended December 31, 2014, 2015 and 2016</u>	<u>52</u>
<u>Consolidated Statements of Changes in Stockholders' Equity for the Years Ended December 31, 2014, 2015 and 2016</u>	<u>53</u>
<u>Consolidated Statements of Cash Flows for the Years Ended December 31, 2014, 2015 and 2016</u>	<u>54</u>
<u>Notes to Consolidated Financial Statements</u>	<u>55</u>
<u>Management's Report on Internal Control over Financial Reporting</u>	<u>99</u>

### (2) FINANCIAL STATEMENT SCHEDULES

The following Financial Statement Schedule is included in this Form 10-K on the page indicated:

	<u>Page</u>
<u>Financial Statement Schedule II — Valuation and Qualifying Accounts</u>	<u>97</u>

All other schedules are omitted as the required information is inapplicable or the information is presented in the Consolidated Financial Statements or related notes.

### (3) EXHIBITS

A copy of this Form 10-K, excluding exhibits, will be furnished at no charge to each person to whom a proxy statement for our 2017 annual meeting of stockholders is delivered upon the request of such person. Exhibits to this Form 10-K are available upon payment of a reasonable fee, which is limited to our expenses in furnishing the requested exhibit. Requests for copies should be directed to our Corporate Secretary, by mail at 3040 Post Oak Boulevard, Suite 300, Houston, Texas 77056 or by phone at 1-866-332-8400 or 713-332-8400.

<u>Exhibit No.</u>	<u>Description</u>
2.1	Asset Sale Agreement, dated as of March 3, 2014, by and among Carriage Services of Louisiana, Inc., Carriage Funeral Holdings, Inc., SCI Louisiana Funeral Services, Inc., S.E. Funeral Homes of Louisiana, LLC and S.E. Funeral Homes of Virginia, LLC. Incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed March 5, 2014.
3.1	Amended and Restated Certificate of Incorporation, as amended, of the Company. Incorporated by reference to Exhibit 3.1 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 1996.
3.2	Certificate of Amendment dated May 7, 1997. Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for its fiscal quarter ended September 30, 1997.
3.3	Certificate of Amendment dated May 7, 2002. Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for its fiscal quarter ended June 30, 2002.
3.4	Amended and Restated Bylaws of the Company. Incorporated by reference to Exhibit 3.2 to the Company's Registration Statement on Form S-1/A (File No. 333-05545) filed on July 18, 1996.

- 3.5 Amendments to the Bylaws of the Company effective December 18, 2000. Incorporated by reference to Exhibit 3.8 to the Company's Annual Report on Form 10-K for its year ended December 31, 2000.
- 3.6 Amendments to the Bylaws of the Company effective May 20, 2008. Incorporated by reference to Exhibit to the Company's current report on Form 8-K filed May 28, 2008.
- 4.1 Indenture, dated as of March 19, 2014, by and among Carriage Services, Inc. and Wilmington Trust, National Association, as Trustee. Incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed March 19, 2014.
- 10.1 Credit Agreement dated August 30, 2012, among Carriage Services, Inc. as the Borrower, and Bank of America, N.A. as the Administrative Agent and Sole Lender. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed September 4, 2012.
- 10.2 First Amendment to Credit Agreement dated November 29, 2012, among Carriage Services, Inc. as the Borrower, and Bank of American N.A. as the Administrative Agent and Sole Lender. Incorporated by reference to Exhibit 10.3 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2012.
- 10.3 Second Amendment to Credit Agreement dated February 14, 2013, among Carriage Services, Inc. as the Borrower, and Bank of America, N.A. as the Administrative Agent and Sole Lender. Incorporated by reference to Exhibit 10.4 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2012.
- 10.4 Third Amendment and Commitment Increase dated April 23, 2013 among Carriage Services, Inc., the Lenders and Bank of America, N.A. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed April 25, 2013.
- 10.5 Fourth Amendment to Credit Agreement, dated as of February 27, 2014, by and among Carriage Services, Inc., the banks listed on the signature page thereto and Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed March 5, 2014.
- 10.6 Fifth Amendment to Credit Agreement, dated as of April 14, 2014, by and among Carriage Services, Inc., the banks listed on the signature page thereto and Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on April 16, 2014.
- 10.7 Sixth Amendment to Credit Agreement, dated May 20, 2015, by and among the Company, Bank of America, N.A., as Administrative Agent, and the other lenders party thereto. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 22, 2015.
- 10.8 Seventh Amendment to Credit Agreement, dated February 9, 2016, by and among the Company, Bank of America, N.A., as Administrative Agent, and the other lenders party thereto. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on February 9, 2016.
- 10.9 Second Amended and Restated Employment Agreement dated March 14, 2012 between Carriage Services, Inc. and Melvin C. Payne. Incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed March 20, 2012. †
- 10.10 First Amendment to Second Amended and Restated Employment Agreement by and between Carriage Services, Inc. and Melvin C. Payne dated March 3, 2014. Incorporated by reference to Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for its quarter ended March 31, 2014. †
- 10.11 Indemnity Agreement with Melvin C. Payne dated December 18, 2000. Incorporated by reference to Exhibit 10.20 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2000. †
- 10.12 Employment Agreement by and between Carriage Services, Inc. and David J. DeCarlo dated March 3, 2014. Incorporated by reference to Exhibit 10.6 to the Company's Quarterly Report on Form 10-Q for its quarter ended March 31, 2014. †

- 10.13 Employment Agreement with Mark R. Bruce dated January 4, 2011. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for its quarter ended March 31, 2013. †
- 10.14 Employment Letter with Mark R. Bruce dated March 14, 2012. Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for its quarter ended March 31, 2013. †
- 10.15 Employment Agreement with Shawn R. Phillips dated January 4, 2011. Incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for its quarter ended March 31, 2013. †
- 10.16 Employment Letter with Shawn R. Phillips dated March 14, 2012. Incorporated by reference to Exhibit 10.4 to the Company's Quarterly Report on Form 10-Q for its quarter ended March 31, 2013. †
- 10.17 Employment Agreement with Paul D. Elliott dated August 31, 2012. Incorporated by reference to Exhibit 10.5 to the Company's Quarterly Report on Form 10-Q dated March 31, 2013. †
- 10.18 Second Amended and Restated 2006 Long-Term Incentive Plan. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2012. †
- 10.19 First Amendment to Carriage Services, Inc. Second Amended and Restated 2006 Long-Term Incentive Plan. Incorporated by reference to Exhibit 10.28 to the Company's Annual Report on Form 10-K filed March 5, 2014. †
- 10.20 Amended and Restated Carriage Services, Inc. 2007 Employee Stock Purchase Plan. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for its quarter ended September 30, 2013. †
- 10.21 Form of Employee Performance-Based Stock Award Agreement. Incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed August 7, 2012. †
- 10.22 Form of Director Performance-Based Stock Award Agreement. Incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2012. †
- 10.23 Director Compensation Policy dated March 5, 2012. Incorporated by reference to Exhibit 10.24 to Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2011. †
- 10.24 Incentive Stock Option Agreement Under Carriage Services, Inc. Second Amended and Restated 2006 Long-Term Incentive Plan. Incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2013. †
- 10.25 Restricted Stock Agreement Under Carriage Services, Inc. Second and Amended and Restated 2006 Long-Term Incentive Plan. Incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for its quarter ended June 30, 2013. †
- 10.26 Form of Employee Performance Award Agreement. Incorporated by reference to Exhibit 10.24 to the Company's Annual Report on Form 10-K for its fiscal year ended December 31, 2015. †
- 10.27 Retirement and Release Agreement dated effective September 30, 2016 between Carriage Services, Inc. and David J. DeCarlo. Incorporated by reference to Exhibit 10.1 to the Company's Form 8-K filed on October 3, 2016. †
- \*12.1 Computation of Ratio of Earnings to Fixed Charges.
- \*21.1 Subsidiaries of the Company.
- \*23.1 Consent of Grant Thornton LLP.
- \*31.1 Certification of Periodic Financial Reports by Melvin C. Payne in satisfaction of Section 302 of the Sarbanes-Oxley Act of 2002.
- \*31.2 Certification of Periodic Financial Reports by Viki K. Blinderman in satisfaction of Section 302 of the Sarbanes-Oxley Act of 2002.

\*\*32 Certification of Periodic Financial Reports by Melvin C. Payne and Viki K. Blinderman in satisfaction of Section 906 of the Sarbanes-Oxley Act of 2002 and 18 U.S.C. Section 1350.

\*101 Interactive Data Files.

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(\*) Filed herewith.

(\*\*) Furnished herewith.

(†) Management contract or compensatory plan or arrangement.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on February 23, 2017.

### CARRIAGE SERVICES, INC.

By: /s/ Melvin C. Payne  
**Melvin C. Payne**  
Chief Executive Officer and Chairman of the Board

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Melvin C. Payne</u> <b>Melvin C. Payne</b>	Chief Executive Officer and Chairman of the Board (Principal Executive Officer)	February 23, 2017
<u>/s/ Viki K. Blinderman</u> <b>Viki K. Blinderman</b>	Senior Vice President, Principal Financial Officer, Chief Accounting Officer and Secretary (Principal Financial Officer)	February 23, 2017
<u>/s/ Adeola Olaniyan</u> <b>Adeola Olaniyan</b>	Corporate Controller and Principal Accounting Officer	February 23, 2017
<u>/s/ Donald D. Patteson Jr.</u> <b>Donald D. Patteson Jr.</b>	Director	February 23, 2017
<u>/s/ James R. Schenck</u> <b>James R. Schenck</b>	Director	February 23, 2017
<u>/s/ Barry K. Fingerhut</u> <b>Barry K. Fingerhut</b>	Director	February 23, 2017
<u>/s/ Bryan D. Leibman</u> <b>Bryan D. Leibman</b>	Director	February 23, 2017



# CORPORATE INFORMATION

Carriage Services is a leading provider of deathcare services and merchandise in the United States. As of December 31, 2016, Carriage operated 170 funeral homes in 28 states and 32 cemeteries in 11 states.

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## Board of Directors

**Melvin C. Payne**

*Chief Executive Officer and Chairman of the Board*

**Bryan D. Leibman**

*President and Chief Executive Officer, Frosch Travel*

**Barry K. Fingerhut**

*Chief Executive Officer, Certification Partners, LLC*

**Donald D. Patteson, Jr.**

*Investor*

**James R. Schenck**

*President and Chief Executive Officer, PenFed Credit Union*

## Operations and Strategic Growth Leadership Team

**Melvin C. Payne**

*Chief Executive Officer and Chairman of the Board*

**Mark R. Bruce**

*Executive Vice President and Chief Operating Officer*

**Viki K. Blinderman**

*Senior Vice President, Principal Financial Officer, Chief Accounting Officer and Secretary*

**C. Benjamin Brink**

*Senior Vice President, Chief Financial Officer and Treasurer*

**Shawn R. Phillips**

*Senior Vice President and Head of Strategic and Corporate Development*

**Paul D. Elliott**

*Senior Vice President and Regional Partner*

**Brijesh K. Patel**

*Vice President and Head of Operations and Analysis Planning Group*

**Gabriel Q. Ngo**

*Vice President and Head of Operations and Acquisitions Support*

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## Independent Public Accountants

Grant Thornton LLP, Houston, Texas

## Form 10-K Availability

The Company's Annual Report on Form 10-K for the year ended December 31, 2016 may be obtained by writing to: Investor Relations, Carriage Services, Inc., 3040 Post Oak Boulevard, Suite 300, Houston, Texas 77056; via the Company's website: [www.carriageservices.com](http://www.carriageservices.com); or via the SEC's website: [www.sec.gov](http://www.sec.gov).

## Transfer Agent & Registrar

American Stock Transfer & Trust Company, LLC  
6201 15th Avenue  
Brooklyn, New York 11219  
800-937-5449  
[www.astfinancial.com](http://www.astfinancial.com)

## Houston Support Office

Carriage Services, Inc.  
3040 Post Oak Boulevard, Suite 300  
Houston, Texas 77056  
713-332-8400  
[www.carriageservices.com](http://www.carriageservices.com)

## Common Stock

Carriage Services, Inc.'s common stock is traded on the New York Stock Exchange under the symbol "CSV".

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## Forward-looking Statements

Certain statements made in this Annual Report by or on behalf of the Company that are not historical facts are intended to be forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are based on assumptions that the Company believes are reasonable; however, many important factors, as discussed under "Forward-Looking Statements" in the Company's Form 10-K for the year ended December 31, 2016, could cause the Company's results in the future to differ materially from the forward-looking statements made herein and in any other documents or oral presentations made by or on behalf of the Company.



Carriage Services, Inc.  
3040 Post Oak Boulevard, Suite 300  
Houston, Texas 77056

713-332-8400  
[www.carriageservices.com](http://www.carriageservices.com)